



PHD

Possible causes of tax evasion and avoidance with particular reference to Australia.

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POSSIBLE CAUSES OF TAX EVASION AND AVOIDANCE
WITH PARTICULAR REFERENCE TO AUSTRALIA

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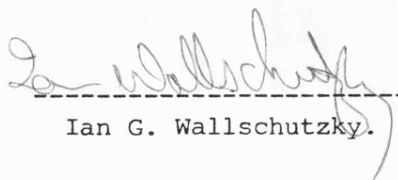
Ian Gregory WALLSCHUTZKY

for the degree of Ph.D.
of the University of Bath
1983.

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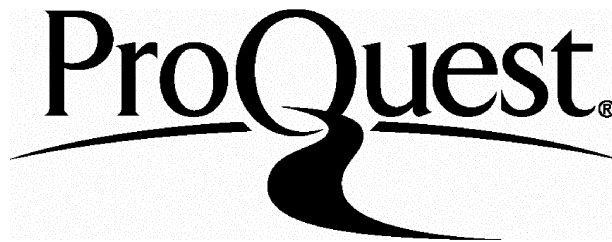
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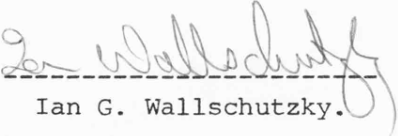
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SUMMARY

The purpose of this thesis was to enquire into the possible causes of tax evasion and avoidance and to suggest reforms which might be considered by the legislature to limit those practices. It was shown that it is possible to resolve the possible causes of evasion and avoidance into two components: namely, the opportunity that exists in a tax system for those practices and the motivating influences which cause taxpayers to undertake them. By way of example the Australian income tax system and Australian taxpayers were studied. A brief summary of results follows.

Analysis of the Australian tax system revealed that inadequate bookkeeping requirements, inadequate resources used to detect evasion, anomalies in the penalty structure and failure to deduct tax at source for all types of income contributed to the level of evasion. Greatest scope for avoidance arose because of the failure of the Australian tax system to prevent income splitting, failure to tax all capital gains and failure to quickly remedy legislative defects. Further, the large number of exemptions to the tax base and the failure of the general anti-avoidance provision (s.260) also contributed to the level of avoidance.

Testing of various hypotheses about taxpayer behaviour suggested that the most important hypothesis was the *exchange relationship* hypothesis and that the main element of this was taxpayers' perception that tax rates were too high. Some support was also found for the *social orientation* hypothesis and the *administrative control* hypothesis. Though it was not the primary purpose of this thesis to outline reforms,

some reforms were suggested. These covered reforms to remedy systemic weaknesses, for example introduction of a flat rate of tax and a capital gains tax, and reforms to affect taxpayer behaviour: for example, greater use of the media to improve taxpayers' knowledge of Government spending, Government need for taxpayers' money and Tax Office enforcement activities.

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INTRODUCTION

There are a number of reasons why tax evasion and avoidance are worthy of study. Not only do they result in a loss of revenue but they also shift the tax burdens, which would otherwise have been imposed, from those who avoid or evade tax onto those who do not. The extent of the problem of tax evasion and avoidance, in the Australian context, is shown in the following extracts: the first is from the annual report of the Commissioner of Taxation and indicates the extent of the loss of revenue from one of these activities, tax avoidance; the second is from a speech in Parliament by the Treasurer when, on 27 May 1981, he introduced new general anti-avoidance provisions and indicates the resulting inequities.

In the 59th and earlier Reports I recorded the adverse effect that investigations of tax avoidance activities had upon limited staff resources and collection of tax. Unfortunately I am unable to report any significant improvement for 1980-81. some \$973m of tax assessed in tax avoidance schemes that are under administrative challenge remained uncollected at the end of June 1981. ¹

There is widespread abhorrence of blatant tax avoidance of the kind that we have recently experienced. It distorts in a most unacceptable way the relative burdens of tax that are borne by different sectors of the community ... unless something is done along general lines there is a very real danger that our income tax legislation will become so voluminous and so complicated as to be virtually incomprehensible. ²

The second extract highlights another problem which results from attempts to remedy defects in our tax laws, namely, their increasing complexity. In fact, over the last ten years one loose leaf reporter (C.C.H.) on income tax legislation has increased, on average, by almost one hundred pages per year. When the service was introduced in 1969 the reporter stood at 663 pages whereas presently (1 December 1982)

it was almost three times that size and was of more compact form.³

Another example of the increasing complexity is the legislation before Parliament in November 1982 to recoup tax in one tax evasion racket.

The *recoupment tax legislation*⁴ extends to some sixty-one pages.

By the time this thesis was nearing completion official estimates of revenue lost from *tax avoidance* schemes had increased as Table A shows:

TABLE A

Total Tax Outstanding, as at 8 October, 1982
as a Result of Tax Avoidance Schemes

	<u>Amount</u>
Individuals	\$609m
Trusts	158
Companies	<u>268</u>
-	\$1035m*
	=====

* approximately Stg £ 600m.

Source: 61st Report of the Commissioner of Taxation
1981-82, Commonwealth Government Printer,
Canberra, October 1982.

It is the purpose of this thesis to enquire into the possible causes of tax evasion and avoidance and to suggest reforms which might be considered by the Legislature to limit those practices. The enquiry will be divided into two main parts. Firstly, an enquiry will be made into the *opportunity*, in the Australian tax system, for such practices and secondly, an enquiry will be made into the *motivating factors* which influence taxpayers' behaviour. *Opportunity* is seen as the scope within a tax system for evasion and avoidance activities. This scope reflects weaknesses in a tax system which can be controlled. *Motivating factors* are seen as the inner driving forces which cause taxpayers to

undertake evasion or avoidance activities. They are the antecedent factors which cause such behaviour. In this thesis there was a basic problem in trying to determine the relevant motivating factors. Two broad approaches were used and each had their own shortcomings. The first approach was to determine taxpayers' *attitudes* to a variety of questions and the second was to ask taxpayers and tax agents to state why they thought taxpayers evaded or avoided tax.

Attitudes were regarded as being akin to reasonably settled opinions, being based on some degree of thought or analysis. Unfortunately as with many social surveys attitudes are not necessarily equivalent to behaviour, nor are they necessarily good predictors of it. Some studies have shown consistency between attitudes and behaviour but this consistency need not always hold. In the context of this thesis it could be argued that if anti-tax attitudes were held strongly enough and if there was opportunity for evasion then, perhaps, attitudes and behaviour would very likely be consistent.

Reasons were seen as ex-post rationalisations of what had been done. Again, these might not have been consistent with ex-ante factors (the motivating factors). Thus convicted evaders, when asked why they thought people felt justified in evading tax, might or might not have given honest or fully considered responses. They might have given answers which they thought would be acceptable to the interviewer. On the other hand, they might have been influenced in giving their answers by things they had read in earlier parts of the questionnaire. Alternatively they might not have known what actually caused taxpayers to evade. This ignorance may have been due to evasion being the result of a combination of motives or it may have been due to a single or a few factors which were difficult to explain. Notwithstanding these difficulties, attitudes

and reasons were used as surrogates for motives for want of a more suitable approach. Attitudes were seen as the intervening variable between motives and behaviour and as something which could be determined. The approach used to determine the opportunity for evasion and avoidance in a tax system seemed less prone to criticism and is not especially justified in this part.

The author felt there was good reason why both *opportunity* and *motivating factors* should have been studied. While it may be true that enough controls can be built into a tax system to prevent individual evasion or avoidance such controls may not be able to prevent mass evasions or avoidances. Tax systems in modern democratic societies are only successful if they are generally accepted. Tax systems which employ too many controls, or controls which are very rigid, or which infringe the rights of individuals might lead to general tax revolt. Schmolders (discussed in detail at 2.4.1) argues that "willingness of taxpayers to co-operate" could, at some point, reach an optimum after which increased controls could lead to reduced co-operation. If increased taxpayer co-operation is required then other means have to be employed. This is where the motivating factors could assume importance. Additionally it might be far too costly to devise a tax system which allowed no scope for avoidance or evasion.

Once the causes of avoidance and evasion have been determined recommendations can then be made on how taxpayers' behaviour can be influenced to make them more compliant and how systemic weaknesses in our tax system can be remedied to allow less scope for evasion and avoidance practices. The first task though is defining the two terms "tax evasion" and "tax avoidance". This is the function of Chapter One.

As with much that is written about taxation no sooner is it written than it becomes out of date, especially matters dealing with tax law. In this thesis a cut-off date had to be selected. This date was 1 December 1982. Accouncements made, legislation enacted and cases decided after this date have not been incorporated in this thesis.

FOOTNOTES TO INTRODUCTION

1. Sixtieth Report of the Commissioner of Taxation 1980-81
Commonwealth Government Printer, Canberra 1981, p.12.
2. The Hon. John Howard, *Income Tax Laws Amendment Bill (No.2)*
1981 Second Reading Speech, p.2.
3. Earlier figures taken from I.V. Gzell, "What's Ahead in Tax",
The Chartered Accountant in Australia, September 1980, pp.39-44.
4. The relevant legislation is, in essence, contained in the
Taxation (Unpaid Company Tax) Assessment Bill 1982 and the
Taxation (Unpaid Company Tax) Bill 1982. There are, however,
some other minor or consequential Bills.

CHAPTER ONE

THE MEANING OF THE TERMS 'TAX EVASION' AND 'TAX AVOIDANCE'

1.1 INTRODUCTION

There has been a growing number of empirical investigations in a number of countries into the causes and effects of *tax evasion* and *tax avoidance*. However, it is not altogether clear whether these investigations proceed from a common definition of these two terms. If results are influenced by the terms used then lack of definition of these terms limits the usefulness of particular studies and makes comparative analysis tenuous. More is required to be known about the two terms than the fact that one (tax avoidance) is legal and the other (tax evasion) is illegal. Certainly more is required to be known than one writer lightheartedly suggested: "If *you* have a bright plan on how to save taxes that is avoidance. If *somebody else* has a scheme to save taxes that is evasion."¹ The purpose of this chapter is to attempt to determine what is meant by the terms "tax evasion" and "tax avoidance".

1.2 THE NEED FOR A DISTINCTION BETWEEN TAX EVASION AND TAX AVOIDANCE

The need for a distinction between the terms "tax evasion" and "tax avoidance" can be approached from a number of different viewpoints including the government, the taxation authorities, the Courts and the taxpayers themselves. A government's need to distinguish the two, particularly the former, was well pointed out by the Radcliffe Commission in 1955: "... until some certainty is reached upon this question of

definition the question of what sort of steps should be taken to prevent it remains an aimless one."²

It is possible that once a suitable definition is found a government might decide not to take any action to prevent tax evasion or tax avoidance because the costs of doing so might outweigh the benefits obtained. Such costs and benefits cannot be determined without knowing precisely what it is that is being measured. On the other hand the existence of widespread tax avoidance and evasion might simply reflect the need for reform of the tax system itself, to remedy defects and inequities in it.

Taxation authorities and Courts require a clear distinction between the two terms to enable tax laws to be administered and enforced. Further, the type and size of the penalty, if any, which ought to be imposed on tax offenders will depend on the nature of the offence: whether it was lawful or unlawful, whether it was large or small, and whether it was serious or not serious.

The question of what is lawful and what is unlawful is only one of the questions which require attention. Often tax laws attempt to anticipate tax avoidance by including a general anti-avoidance provision. It is the duty of a taxation authority to administer such a provision and the duty of the Courts, where there are conflicts between the taxation authority and taxpayers, to interpret it. Taxpayers also require a clear statement of their responsibilities, rights and duties so that they can order their affairs accordingly. Finally, researchers cannot be confident of their findings on the nature and extent of tax evasion or tax avoidance, or their causes and effects, without adequate definition of the two terms. It is encouraging that at least some researchers

recognise the importance of defining the two terms before investigating them: "The extent of tax avoidance is not known. Nor indeed, without much more careful definition of the phenomenon, could we ever hope to know it."³

The method adopted to distinguish the two terms "tax evasion" and "tax avoidance" will begin with an historical review of income tax in the United Kingdom. This review should help determine when those terms were first used and to which activities those terms were first applied.

The United Kingdom is chosen as a point of reference because income tax evasion and avoidance seem to have been widespread there before income tax had really established itself in Australia. Federal income tax in Australia was not introduced until 1915 and evasion of income tax seemed to be widespread in the United Kingdom almost three-quarters of a century beforehand. As early as 1845 Lord John Russell said:

I believe no man who had been concerned in the collection of this tax will deny that his experience has shown that great frauds are practised under this tax ... those who wished to evade the tax, either found the means of doing so or entangled themselves and the Government in the most expensive proceedings.⁴

1.3 INCOME TAX IN THE UNITED KINGDOM 1799 to 1920

One historical account of income tax in the United Kingdom suggests that:

Taxation and evasion are complementary twins, and in England resistance to taxation had a long and not always dishonourable history from Wat Tyler to John Hampden.⁵

This view is supported by instances of evasion of many different types

of tax. In fact there does not seem to have been any tax in the United Kingdom which has escaped evasion. Some of the more notable examples of evasion were:

- (i) evasion of the poll tax of 1377. When the taxes of 1380 were collected "it appeared that the population had fallen, since the poll tax of 1377, by nearly half a million."⁶ The tax was abandoned in 1380;
- (ii) evasion of the window tax of 1696. This tax did not yield the revenue expected of it because "taxpayers hit upon the simple plan of stopping up windows in preparation for the assessor's visit and re-opening them on his departure;"⁷ and
- (iii) evasion of the tax on silver plate in 1765. This tax was also easy to evade. When tax gatherers called the silver plate was hidden.

These instances of evasion were not isolated ones. In some cases evasion was so widespread that it was no longer possible to persevere with the tax, as seen with the poll tax. The first serious attempt in the United Kingdom to tax income was made in 1799 and this was also subject to widespread evasion. The tax in 1799 yielded only about 60% of that budgeted with much of the shortfall due to evasion.⁸ Income tax was withdrawn in 1816 but reintroduced in 1842. Although the rate of tax in 1842 was only seven pence in the pound, with a general exemption from tax where income was less than £150 p.a., evasion appears to have been widespread.⁹

By 1901 the rate of tax had doubled to fourteen pence in the pound and for the first time collections from direct taxation exceeded those from indirect taxation. However, income tax evasion had become a more serious problem. So much so that, in 1905, a Government Committee "had as the first of its terms of reference to enquire into 'the prevention

of fraud and evasion'." ¹⁰ However, it is significant that although there had been a substantial increase in the amount of income tax being evaded the *means* by which it was achieved had scarcely changed since 1842:

There were still only four main methods of evasion; by omission to make returns, ..., by fraudulent returns, by appeals against assessments ... and by incomplete accounts or erroneous deductions put forward in good faith. ¹¹

It is also significant that until this time no mention was made of *tax avoidance* as a means to reduce tax liabilities. This suggests that either no tax avoidance was detected or what is now known as tax avoidance may then have been referred to as evasion. However there seems little reason to support the latter. It would seem that little avoidance was detected because little was carried out:

... but for the first time (1906) the phrase 'legal avoidance' as distinct from mere evasion makes its appearance, instances being the free exchange of coupons on foreign securities and virtual direction from this country (U.K.) of companies situated abroad. ¹²

Avoidance does not appear to have become a serious problem until after the First World War when high rates of excess profits duties and complex laws imposing them combined to precipitate the first significant era of tax avoidance in the United Kingdom. Extracts from the 1920 Budget Committee give some clues as to the nature of avoidance at this time:

... it would strengthen the position of the authorities in their dealings with the taxpayer who seeks to avoid the tax *by so arranging his business* that the intention of the law is defeated, if power were given similar to that now existing under the provisions of the E.P.D. Act, that is to say, the power of ignoring, for the purposes of assessment *any fictitious or artificial transactions* entered into for the purposes of evading or avoiding income tax. ¹³

[emphasis added]

Avoidance was seen to be the circumvention of the law by arrangements, transactions or other business dealings which appeared fictitious or artificial. Both in intent and effect avoidance was similar to evasion although unlike evasion it was carried out within the law.

The assistance that the findings of these early government committees has provided suggests that further insights might come from a review of the findings of other committees. Therefore it is proposed to review more recent reports, made for governments, in which the question of tax avoidance and evasion has been addressed as a major issue. Reports prepared in Canada, Australia and the United Kingdom, will be examined with the hope of finding more universal definitions of the terms "tax evasion" and "tax avoidance". The reports to be reviewed are:

- *The Royal Commission on Taxation of Profits and Income*¹⁴
Final Report U.K. 1955 (hereinafter referred to as 'the Radcliffe Commission')
- *The Report of the Royal Commission on Taxation*¹⁵ Canada
1966 (hereinafter referred to as 'the Carter Commission')
- *The Taxation Review Committee - Full Report*¹⁶ Australia
1975 (hereinafter referred to as 'the Asprey Committee').¹⁷

1.4 GOVERNMENT ENQUIRIES INTO THE NATURE OF TAX EVASION AND TAX AVOIDANCE

1.4.1 The Radcliffe Commission

The Radcliffe Commission prefaced their discussion on tax avoidance with the caution that "the phrase (tax avoidance) was used to denote something which a tax system ought to be concerned to control."¹⁸ This caution is often overlooked when the Commission's definition is used. However, it ought not be overlooked as it implies that if the phrase

"tax avoidance" was to be defined for another purpose it might take a different meaning. For their purpose the Commission's definition was given as follows:

It is usual to draw a distinction between tax avoidance and tax evasion. The latter denotes all those activities which are responsible for a person not paying the tax that the existing law charges on his income. *Ex hypothesi* he is in the wrong, though his wrong doing may range from the making of a deliberately fraudulent return to a mere failure to make a return or to pay his tax at the proper time. By tax avoidance, on the other hand, is understood some act by which a person so arranges his affairs that he is liable to pay less tax than he would have paid but for the arrangement. Thus the situation which he brings about is one in which he is legally in the right, ... ¹⁹

This definition maintains the clear legal distinction between tax avoidance and tax evasion with only the former being within the law. Further, it ought to be emphasised that the range of activities which the Commission specify as constituting instances of tax evasion do not differ materially from those outlined already.

The Radcliffe Commission also gave examples of tax avoidance activities which it considers the tax system ought to control:

... the tax avoidance that should be struck at is to be found in those situations in which a man, without being in law the owner of income, yet has in substance the power to enjoy it or to control the disposition of it in his own interest. ²⁰

and in relation to companies:

But, as things are, the tax avoidance against which legislation has been directed has taken the shape of transactions designed to take advantage of these special provisions and so to escape or reduce the tax otherwise payable. ²¹

It appears that opportunity for these instances of tax avoidance arose out of features of the tax system itself. Had there not been a progressive rate structure individuals would not have saved tax by

splitting income. Avoidance of tax by companies was also partly attributable to the features of the tax system, particularly the rate structure and the complexity of particular provisions. This was recognised by the Radcliffe Commission.

Indeed, if the charge (to profits tax) were imposed in a single form, without exemptions or qualifications or variations of rate, it might be that the question of tax avoidance by companies would not arise at all.²²

Three instances of tax avoidance by companies were outlined by the Radcliffe Commission, which conceded that each was "invited" by particular provisions themselves.²³

1.4.2 The Carter Commission

The Carter Commission accepted, unequivocally, the Radcliffe Commission's definition of tax evasion. It also, in essence, accepted their definition of tax avoidance. However in the Carter Commission's discussion on tax avoidance there was a distinction between those types of tax avoidance which it considered ought not be limited in any way and those against which there should be legislative action. Instances of the former included a person reducing his tax liability by preferring leisure to work or by making a gift to charity. However the Commission argued that where a person "contrives matters in such a way that he continues to enjoy the benefits of income, or if he continues to control that source or disposition of income, he should not be allowed to reduce his liability."²⁴ Taxpayer action which was regarded to be of a type which the legislature ought not permit, included income splitting through trusts, dividend stripping, trading in loss companies, converting income into capital by means of a premium and transferring the source of income to jurisdictions where the rate of tax was lower. The distinguishing feature of the two broad types of tax avoidance, from the Carter Commission's point of view,

seems to rest with the motives of the taxpayers for undertaking particular arrangements.

For our purposes, as will be elaborated below, the expression 'tax avoidance' will be used to describe every attempt by legal means to prevent or reduce tax liability which would otherwise be incurred, by taking advantage of some provision or lack of provision in the law ... it presupposes the existence of alternatives, one of which would result in less tax than the other. Moreover, motive would seem to be an essential element of tax avoidance. A person who adopts one of several possible courses because that one will save him the most tax must be distinguished from the taxpayer who adopts the same course for business or personal reasons. ²⁵

The Commission guarded themselves from possible criticism by adding that a taxpayer's purpose was to be "assumed from the circumstances and the nature of the transactions". ²⁶

1.4.3 The Asprey Committee

The Asprey Committee's definitions appear at the beginning of their chapter on "Income Splitting". Their definitions of the terms tax evasion and tax avoidance were also accompanied by examples of each:

The phrase 'tax evasion' describes an act in contravention of the law whereby a person who derives a taxable income either pays no tax or pays less tax than he would otherwise be bound to pay. Tax evasion includes the failure to make a return of taxable income or the failure to disclose in a return the true amount of income derived

and

... tax avoidance on the other hand usually connotes an act within the law whereby income, which would otherwise be taxed at a rate applicable to the taxpayer who but for that act would have derived it, is distributed to another person or between a number of other persons who do not provide a *bona fide* and fully adequate consideration; in the result that the total tax payable in respect of that income is less than it would have been had no part of the income been distributed and the whole had been taxed as income of that taxpayer. ²⁷

The means by which tax avoidance was carried out "was most frequently to be seen in partnerships, alienation of income, trusts, private company arrangements, loans, gifts and employer/employee relationships".²⁸ The Committee recognised that there was "a very fine line to be drawn between the transaction which offended and the one which merited no condemnation"²⁹ yet it attempted to outline the features of those types of tax avoidance which should be prevented:

... unless the arrangement was an ordinary business transaction creating rights and obligations that would normally be created between people dealing at arms length in a transaction of the nature in question and effected by means normally employed in such a transaction, or was made in the ordinary course of changing an investment, or was a bona fide arrangement of a person's or a family's affairs, and the Commissioner was satisfied that the arrangement was not entered into solely or primarily for the purpose of obtaining the tax advantage or that one of its main objects was to obtain the tax advantage.³⁰

The Asprey Committee's definition of tax evasion is no different from that already outlined by the two Royal Commissions. Their definition of avoidance is similar but it distinguishes between those types of avoidance which were intended by the legislature and those which were not. Both types of avoidance are within the law and are therefore different from instances of evasion which are outside the law.

Examples of tax evasion, whether taken from Government Committee Reports in the United Kingdom in 1851 or from Australia in 1975 bear remarkable resemblance. The means by which taxes have been evaded have changed little during that time and this facilitates an understanding of the phrase "tax evasion". Perhaps one of the few "new" means of evading tax was evidenced in a recent court case. A tax assessor from the Parramatta Office was convicted after pleading guilty to accepting bribes to ensure incorrect assessments for certain taxpayers. The assessor provided

accomplices with written instructions on how to get larger refunds on their returns. The returns were taken to the Tax Office where the assessor would have them processed using a bogus stamp and false initials. In return he was paid half the additional refund.³¹

1.4.4 Recent Developments in Official Thinking

Over recent years in Australia the only substantial changes affecting income tax evasion practices have been (i) the introduction of *The Crimes (Taxation Offences) Act 1980*³² and (ii) the Treasurer's announcements on 25 July, 1982 and 17 August, 1982 of the Government's intention to recover company taxes from vendor shareholders who participated in certain tax evasion practices including those covered by the above Act.

The operation of *The Crimes (Taxation Offences) Act 1980* will be discussed later in this thesis but it is relevant to examine its scope here. The provisions of the Act are directed at two main kinds of tax evasion practices:

- (i) The first ensures that a company is stripped of its assets before tax is due and payable or before tax, which will become due and payable on previously derived income, can be collected; and
- (ii) The second is designed to ensure that liability for tax falls from the outset on a "straw"³³ company or trustee which does not have, and was never intended to have, sufficient funds to pay the income tax liability.

Prior to the introduction of legislation to prevent these practices the Commissioner of Taxation had referred to them as "alarming tactics" which would be regarded by most as "pure tax evasion".³⁴ He went on to say that these actions by a company are "the more egregious when members

of the company resolve to place it in voluntary liquidation before an income tax assessment can be issued so that early destruction of records may be achieved."³⁵ These practices, although new, amount to little more than failure to pay tax which has fallen due and so do not expand the definition of tax evasion, notwithstanding the Commissioner's reference to them as "pure tax evasion". Further review of the Commissioner of Taxation Reports reveals features of tax avoidance which are thought to be of a type which should be prevented.

According to the Fifty-ninth Report of the Commissioner of Taxation the features of those tax avoidance arrangements which are likely to be the subject of administrative challenge by the Commissioner are those for which

there is no real commercial purpose;
a great deal of secrecy surrounds them;
they seek to take advantage of provisions of the law
for purposes which could not conceivably have been
intended by the legislature. ³⁶

The features which emerge when one compares these more recent "definitions" of avoidance with earlier ones are the complex legal nature of the avoidance transactions, the predominant purpose of tax avoidance, the lack of commercial reality and the requirement of some degree of secrecy. These attributes are not dissimilar to those outlined by a working party of Organisation For Economic Co-operation and Development's Committee on Fiscal Affairs as the main features of *tax avoidance schemes which aimed to frustrate the intent of the law*:

- (i) Almost invariably there would be present *an element of artificiality*, or to put it another way, the various arrangements involved in a scheme would not in the absence of tax factors, take the form they do;
- (ii) Such schemes would often *take advantage of loopholes in the law* or apply legal provisions for purposes for which they were not intended;

- (iii) *Secrecy may also be a feature of such schemes, where tax advisors sell ready made avoidance devices, one term of the contract of sale being that the taxpayer keeps the facts secret for as long as possible.* ³⁷
[emphasis added]

Tax evasion presupposes that a liability to tax has fallen upon a taxpayer, for example income has been derived by him, and he then takes steps to escape payment of that tax. However in respect of tax avoidance no liability has yet fallen on the taxpayer and before it does, and to prevent it from falling upon him, he takes steps, which are within the law, to get out of its way. Some of the means by which a taxpayer gets out of the way of the tax appear to merit no condemnation from society's point of view, but others do. Often, those which are to be condemned have arisen out of loopholes or lack of definition in particular provisions of the tax laws. They could be said to have resulted from taxpayers' actions which have been against the spirit or intent of the law. Unfortunately there is only a fine line between what was intended by the legislature and that which was not and it is not always possible to say with certainty that this was intended and that was not.

Tax laws often try to anticipate tax avoidance schemes of the latter type by including general anti-avoidance provisions. The Courts, in resolving disputes between taxpayers and taxation authorities, are often required to determine the intent of legislation when it is not clearly expressed by the words used. Consequently an analysis of various Court decisions involving anti-avoidance provisions might be a fruitful means of determining characteristics of those types of tax avoidance which were intended by the legislature and those which were not. In the analysis that follows, selected Court decisions of various countries are examined to see whether a more universal meaning can be attributed to the phrase "tax avoidance". It should be emphasised that only Court decisions of

countries operating under the 'Westminster System'³⁸ are examined.

1.5 THE APPROACH OF THE COURTS TOWARDS INTERPRETING THE TERM "TAX AVOIDANCE"

If the Courts, in interpreting the phrase "tax avoidance", have adopted a common approach it would assist in determining what is meant by that phrase. One working party on fiscal affairs of the Organisation for Economic Co-operation and Development sought to gain further understanding of the term "tax avoidance" by this means.³⁹ They collected examples of judicial decisions from member countries to see whether it was possible to find a common definition. However no single text proved fully adequate because the Courts in different countries had different approaches to interpreting the law. In some countries, such as the Netherlands, the Courts had developed the concept of "fraus legis" to enable them to outlaw transactions which were outside the spirit of the law. Those transactions, being outside the law in those countries, were therefore instances of tax evasion. However, in other countries where the Courts took a different approach to interpretation of tax laws, the same transactions were viewed as avoidance rather than evasion. This meant that different approaches by the Courts to interpreting (tax) laws resulted in different classifications of transactions. Inter-country comparisons, therefore, proved fruitless in the search for common meanings of the terms "tax evasion" and "tax avoidance".

Not only was it found that interpretation of tax laws by the Courts differed but also terminology differed. For example in France tax evasion was referred to as "fraude fiscale" and tax avoidance was referred to as "évasion".⁴⁰ The working party eventually abandoned its attempt to find a common definition by looking at judicial decisions and sought

an alternative approach. With this failure in mind only a brief review of the approach of the Courts in some countries operating under the Westminster System is given here. The underlying spirit of the Westminster System is emphasised in the following extracts:

... if you cannot bring the subject within the letter of the law, the subject is free, however apparently within the spirit of the law the case might otherwise appear to be ⁴¹

... you have no right to assume that there is any governing object which a taxing Act is intended to attain other than that which it has expressed ... by making such objects the intended subject for taxation, you must see whether a tax is expressly imposed ⁴²

My Lords there is a maxim of income tax law which, though it may sometimes be overstressed, yet ought not to be forgotten. It is that the subject is not to be taxed unless the words of the taxing statute unambiguously impose the tax upon him ⁴³

The question is not whether the substance of the transactions is within what may be said to be 'the policy of the Act' or within its spirit and intendment ... But whether the transactions themselves can be said to fall fairly within the terms of that paragraph. ⁴⁴

Unfortunately, for purposes of present analysis, the legislatures of the selected countries have not always used the words "tax avoidance" in their anti-avoidance provisions. The actual words used, the selected countries and cases interpreting those words are summarised below:

<u>Country</u>	<u>Relevant Provision</u>	<u>Relevant Phrase Used</u>
Australia	s.260* <i>Income Tax Assessment Act</i> 1936	"avoiding any duty or liability imposed ..."
[Relevant Australian Case - <i>Newton v FCT</i> ⁴⁵]		
United Kingdom	s.460(1) <i>Finance Act</i> , 1970	"Where ... a person is in a position to obtain, or has obtained a tax advantage ..."
[Relevant United Kingdom Case - <i>IRC v Parker</i> ⁴⁶]		

<u>Country</u>	<u>Relevant Provision</u>	<u>Relevant Phrase Used</u>
New Zealand	s.108 <i>Land and Income Tax Act,</i> 1954	"... altering the incidence of tax or relieving any person from his liability to pay tax ..."
[Relevant New Zealand Case - <i>Mangin v IRC (NZ)</i> ⁴⁷]		
Canada	s.138(1) <i>Income Tax Act</i>	"Where the Treasury Board has decided ... improper avoidance or reduction of taxes ..."
[No relevant Canadian Case ⁴⁸]		

(* Now replaced by Part IVA but no case has been decided in respect of that provision. In any event Part IVA uses the term "tax benefit" rather than the term "tax avoidance".)

Newton's Case was the first case involving s.260 to go before the Privy Council. On behalf of the taxpayers it was submitted that the words "liability imposed on any person" meant a liability which had already accrued and that the word "avoid" meant "displaced". This submission was not accepted by their Lordships who decided that

... the word 'avoid' is used in its ordinary sense in which a person is said to avoid something which is about to happen to him. He takes steps to get out of the way of it ... To 'avoid a liability imposed' on you means to take steps to get out of the reach of a liability which is about to fall on you.⁴⁹

Their Lordships recognised that not all transactions which avoided tax in the sense outlined were intended to be struck down by s.260. To determine which ones should, the following test was laid down:

In order to bring an arrangement within the section, you must be able to predicate - *by looking at the overt acts by which it was implemented* - that it was implemented in that particular way so as to avoid tax. If you cannot so predicate, but have to acknowledge that the transactions are capable of explanation by reference to ordinary business or family dealings, without necessarily being labelled as a means to avoid tax, then the arrangement does not come within the section.⁵⁰

[emphasis added]

It was quite clear from the Privy Council's judgment that merely because an arrangement reduced a taxpayer's tax liability it did not necessarily mean that s.260 applied. Nor did the section apply if the motive behind a taxpayer's action was "tax avoidance". The crucial factor was the *means* by which a reduction in tax liability was achieved.⁵¹

In *Parker's Case* Lord Wilberforce provided the key to interpreting the words "tax advantage" when he stated that the phrase

... presupposes a situation in which an assessment to tax or increased tax, either is made or may possibly be made, that the taxpayer is in a position to resist the assessment by saying *that the way in which he received what is sought to tax prevents him from being taxed on it, and that the Revenue is in a position to reply that if he had received what is sought to tax in another way he would have had to bear tax.*⁵² [emphasis added]

Again the Court emphasised the means by which transactions were carried out was significant in determining whether it was something which the particular provision was designed to prevent. In applying s.460 there were of course two further conditions laid down by the section which must be satisfied, but they have no bearing on the above discussion.

The Privy Council in *Mangin's Case* cited, with approval, the test laid down in *Newton's Case* and then proceeded to give an explanation of the phrase "without necessarily being labelled as a means to avoid tax."

Their Lordships think that what this phrase refers to is ... a scheme ... devised for the sole purpose, or at least the principal purpose, of bringing it about that this taxpayer should escape liability for tax on a substantial part of the income which without it, he would have derived.⁵³

This could be taken to indicate a preference for taxpayer's motive as the criterion for determining whether an arrangement was of a type which was intended to be struck down by the legislature.

1.6 STATUTORY EXTENSION OF THE MEANING OF THE TERMS "TAX EVASION" AND "TAX AVOIDANCE"

Whatever their ordinary meaning the terms "tax evasion" and "tax avoidance" have different meanings if the taxing statute in which they appear provides an alternative definition. The terms as such are not defined in the *Income Tax Assessment Act* 1936, as amended, although, since the introduction of subdivision D of Part III of Division 3 of the Act in 1979, there has been a definition of "tax avoidance agreement". This definition is contained in s.82KH(1) and provides:

'tax avoidance agreement' means an agreement that was entered into or carried out for the purpose, or for purposes that included the purpose, of securing that a person who, if the agreement had not been entered into or carried out, would have been liable to pay income tax in respect of a year of income would not be liable to pay income tax in respect of that year of income or would be liable to pay less income tax in respect of that year of income than that person would have been liable to pay if the agreement had not been entered into or carried out.

However, this definition has relevance only for the subdivision in which it appears. Therefore, it cannot be taken as giving general meaning to the term "tax avoidance". Even the new anti-avoidance provisions, s.177A-G, contain no definition of the term "tax avoidance". The provisions use the term "tax benefit" and apply to deny that benefit where, having regard to a number of specified matters, it would be concluded that the 'scheme' producing the tax benefit was entered into for the purpose of obtaining that benefit. The term 'tax benefit' is exhaustively defined in s.177C(1) of the Act as:

s.177C(1)(a) an amount not being included in the assessable income of the taxpayer of a year of income that would have been included, or might reasonably have been expected to be included, in the assessable income of the taxpayer of that year of income if the scheme had not been entered into or carried out; or

(b) a deduction being allowable to the taxpayer in relation to a year of income where the whole or a part of that deduction would not have been allowable, or might reasonably be expected not to have been allowable, to the taxpayer in relation to that year of income if the scheme had not been entered into or carried out, ...

The terms "avoidance of tax" and "evasion" both appear in paragraph (a) of s.170(2) of the Assessment Act which provides:

Where a taxpayer has not made to the Commissioner a full and true disclosure of all the material facts necessary for his assessment, and there has been an avoidance of tax, the Commissioner may -

- (a) where he is of the opinion that the avoidance of tax has been due to fraud or evasion - at any time;
- (b) ... amend the assessment ...

The use, in this subsection, of the terms "avoidance of tax" and "evasion" was considered by Fullagar, J. in *Westgarth's Case*:⁵⁴

The word 'avoidance' is, I think, to be contrasted with the word 'evasion'. It involves, I think, no notion of escaping by any device or artifice, but conveys simply the notion of actually escaping through not being called upon to pay.⁵⁵

In its context in s.170 the word 'evasion' appears to mean something more than avoidance but something less than fraud. The views of Dixon, J. in a case involving the Commissioner of Taxation (NSW),⁵⁶ seem to outline the accepted meaning of the word 'evasion':

I think it is unwise to attempt to define the word 'evasion'. The context of s.210(2) [the NSW equivalent of s.170(2)] shows that it means more than avoid and also more than a mere withholding of information or the mere furnishing of misleading information. It is probably safe to say that some blameworthy act or omission on the part of the taxpayer or those for whom he is responsible is contemplated.⁵⁷

Within the context of s.170(2) it seems that both 'avoidance' and 'evasion' mean payment of less tax than is legally required, but, in the case of evasion this is achieved by *deliberate* acts or failures to act on the

part of taxpayers. Although the word "evasion" has not been explicitly defined it does seem that it has a slightly different meaning for the purposes of s.170(2) than it might have for ordinary purposes, particularly because it distinguishes between different types of evasions, *viz.* those resulting from deliberate actions of taxpayers and those resulting from failures to act. Where the taxpayer escapes payment of tax by mere failure to furnish information, mere furnishing of misleading information, or where for some other reason he is not called upon to pay the correct amount of tax on his true taxable income, then the term "avoidance of tax" is applicable. This distinction would only seem relevant in s.170(2) as elsewhere these elements would be characterised as evasion.

Section 121F(1), effective from 24 June, 1980 defines "tax avoidance agreement" for the purposes of Division 9C. But again this definition is limited in its scope, as the opening words of s.121F(1) limit the operation of this definition to Division 9C, i.e. it limits it to situations where, as part of a "tax avoidance agreement" income is diverted to an organisation or fund which would otherwise be exempt from tax. The term is defined as follows:

'tax avoidance agreement' means an agreement that was entered into after 24 June 1980 and was entered into or carried out for the purpose, or for purposes that included the purpose, of securing that a person who, if the agreement had not been entered into or carried out, would have been liable to pay income tax in respect of a year of income would not be liable to pay income tax in respect of that year of income or would be liable to pay less income tax in respect of that year of income than that person would have been liable to pay if the agreement had not been entered into or carried out.

The two terms, "tax evasion" and "tax avoidance" are not defined by the *Income Tax Assessment Act* though the terms "tax avoidance agreement" and "tax benefit" are defined. However these definitions are relevant only for the context in which they appear. Thus, in the absence of any

statutory definition to the contrary, the two terms assume their ordinary meaning. The difficulty is then knowing what the ordinary meaning of those two terms is.

1.7 CONCLUSIONS

Of the terms "tax evasion" and "tax avoidance" it would seem that the former is easier to define. Tax evasion is an act in contravention of the law whereby the taxpayer pays less tax than he is legally bound to pay. Evasion presupposes that a liability for tax has already fallen upon a taxpayer who *then* takes steps to escape payment of that tax, either in whole or in part. The methods by which evasion takes place have changed little since income tax was reintroduced in the United Kingdom in 1842. These include failure to make a return, making a fraudulent return and failure to pay tax by the due date. The term "tax avoidance", or "legal avoidance" as it was first called, appears to be a product of the twentieth century. Like evasion, avoidance means that less tax is paid by a particular taxpayer but unlike evasion this end is achieved by means within the law. The distinguishing feature about avoidance is that the taxpayer takes steps to get out of the way of the tax *before* it falls on him. Avoidance occurred, initially, because of defects in particular provisions of taxing statutes. As statutes have become more complex opportunity for avoidance has increased. What is difficult to establish is the means of distinguishing between those types of avoidance which were 'intended' and those which were not. So elusive are the criteria for distinguishing the two that writers have coined a variety of terms when referring to the phrase "tax avoidance". These include the terms 'malevolent avoidance', 'hard core avoidance', 'objective avoidance', 'subjective avoidance', 'economic avoidance',

'improper avoidance', and 'deplorable avoidance'. Each of these probably tries to distinguish between different types of tax avoidance.

One means of distinguishing the two types of avoidance was to examine the way in which Courts, operating under the Westminster System, approached the matter of statutory interpretation. Such Courts give words and phrases their literal meaning unless this leads to some inconsistency or repugnancy with the rest of the statute. If it is not possible to achieve any clear meaning from applying this rule the Courts might apply the mischief rule. In doing so statutes are interpreted to suppress the mischief for which they were introduced to remedy. Application of this rule, though, presumes that the Courts can see what the supposed mischief was.

Applying the literal rule to the phrase "tax avoidance" it became clear that tax was avoided whenever every future possible liability was not attracted. One consequence of this means of interpretation was that a person "avoided tax" by preferring leisure to overtime, or by marrying or by taking out a life assurance policy. A company "avoided tax" whenever it distributed dividends so as not to be liable for undistributed profits tax (i.e. tax imposed by Div. 7). These instances of "tax avoidance" would not have been struck down by a Court given the task of interpreting an anti-avoidance provision because they were usually specifically provided for, and encouraged, by other sections of a taxing statute. Courts would have applied the presumption *generalia specialibus non derogant* to give effect to the provisions of such other sections rather than give literal effect to an anti-avoidance provision. This meant that Courts did not, and in fact could not, interpret the phrase "tax avoidance" in its literal sense. An alternative interpretation is

required, one that will read down the meaning of the phrase so that it is consistent with the other provisions of a taxing statute yet still within the intent of the legislature.

Recognition that some tax avoidance was intended and some was not, really, requires a clear statement by the legislature as to how these should be distinguished. The Courts should not be put in a position of determining rules for this situation because it puts them dangerously close to the realm of policy making. It should not be for the Courts to say which types of tax avoidance are intended or acceptable and which are not. This is a function of the legislature and one which it ought to assume. Until it does confusion will continue to arise around the use of the phrase "tax avoidance". In the meantime the phrase "tax avoidance" should be taken to mean exploitation of provisions, or lack of provision, in a taxing statute by means which, though they legally reduce a person's tax liability which would otherwise accrue, have the appearance of being artificial and of being entered into solely or predominantly for the purpose of reducing tax liability. The means adopted are not those by which one would expect normal business or family dealings to be carried out. As soon as this definition is stated it must be conceded that it has its deficiencies especially from the point of making pronouncements about particular arrangements. However, without a much more definitive statement by the legislature, there is no sure way of determining what is meant. What the above definition suggests is that attention should be focused on the *means* adopted to implement a particular arrangement, transaction or scheme which is suspected of being an instance of (unintended) tax avoidance. The greater the degree of artifice the more likely that the arrangement, transaction or scheme is of a type which was not intended to provide tax savings.

FOOTNOTES TO CHAPTER ONE

1. Vineberg, P.F., "The Ethics of Tax Planning", *British Tax Review*, 1969, No.1, pp.31-48 at p.35.
2. *Royal Commission on the Taxation of Profits and Income*, Final Report, Cmnd 9474, London, HMSO 1955 at para. 1015.
3. Sandford, C.T., *Hidden Costs of Taxation*, London: Institute for Fiscal Studies, 1973, at p.105.
4. Extract taken from Sabine, B.E.V., *A History of Income Tax*, London: George Allen and Unwin, 1966, p.178.
5. *Ibid*, p.179.
6. *Ibid*, p.12.
7. *Ibid*, p.18.
8. *Ibid*, p.33.
9. Lord John Russell, *Hansard*, 17/11/1845 cited in Sabine, B.E.V., *A History of Income Tax*, London: George Allen and Unwin, 1966, p.178.
10. Sabine, B.E.V., *op. cit.*, p.180.
11. *Ibid*, p.180.
12. *Ibid*, p.181.
13. *Ibid*, p.183.
14. *Loc. cit.*, fn.2.
15. *The Report of the Royal Commission on Taxation*, Canada. Ottawa, Canada: Queen's Printer and Controller of Stationery, 1966.
16. *Taxation Review Committee*, Full Report. Canberra: Australian Government Publishing Service, 1975.
17. It should be emphasised that the Asprey Committee was not a Royal Commission as were the Radcliffe and Carter Commissions.
18. *Radcliffe Commission*, *op. cit.*, para. 1015.
19. *Ibid*, para. 1016.
20. *Ibid*, para. 1019.
21. *Ibid*, para. 1030.
22. *Ibid*, para. 1030.
23. *Ibid*, para. 1031.

24. *Carter Commission, op. cit.*, Volume 3, p.542.
25. *Ibid*, p.538.
26. *Ibid*, p.538.
27. *Asprey Committee, op. cit.*, para. 11.1.
28. *Ibid*, para. 11.3.
29. *Ibid*, para. 11.6.
30. *Ibid*, para. 11.44 under the heading "Section 260". This section was, until 27 May 1981, an operative provision of the Australian *Income Tax Assessment Act*, 1936 and was directed against "tax avoidance".
31. Reported in *The Daily Telegraph*, 11 November 1980.
32. N.B. This Act also deals with similar offences in respect of sales tax.
33. The terms "straw company" and "straw trustee" were used by the Treasurer when he introduced *The Crimes (Taxation Offences) Bill* 1980. The terms are intended to indicate that the company or trustee does not have the capacity to pay tax which has fallen due or which might fall due.
34. *Fifty-ninth Report of the Commissioner of Taxation*, Canberra: Commonwealth Government Printer, 1980, Parliamentary Paper No. 181/1980, p.7.
35. *Ibid*, p.7.
36. *Fifty-ninth Report of the Commissioner of Taxation, op. cit.*, fn.34, p.7.
37. Organisation for Economic Co-operation and Development, "Work on Tax Avoidance and Evasion", *Intertax*, January 1980-81, pp.9-16 at p.11.
38. The "Westminster System" is used here to refer to judicial systems such as those operating in the United Kingdom.
39. See *International Tax Avoidance and Evasion*, Doc. 31. Amsterdam: International Bureau of Fiscal Documentation, 1981, pp.11-18.
40. *Ibid*, p.13.
41. *Partington v Attorney General* (1869) LR 4 HL 100 at p.122.
42. *Tennant v Smith* (1892) AC 150 at p.154.
43. *Russell v Scott* (1948) AC 422 at p.433.
44. *Gorton v FCT* (1965) 38 ALJR 353 at p.364.

45. *Newton v FCT* (1958) 98 CLR 1.
46. *IRC v Parker* (1966) 1 All ER 399.
47. *Mangin v IRC* (NZ) (1970) 1 ATR 835.
48. The writer is not aware of any cases that have been decided under this section. Although it should be pointed out that where sections of a taxing statute vest a discretion in a particular person or body it is quite difficult to successfully contest the exercise of that power. On the other hand those entrusted with such a power are often unlikely to use it. See *Carter Commission, op. cit.*, p.570.
49. *Newton's Case, op. cit.*, p.7.
50. *Ibid*, p.8.
51. See in particular Lord Denning's judgment where he says: "The answer to the problem seems to their Lordships to be in the opening words of the section. They show that the section is not concerned with the motives of individuals. It is not concerned with their desire to avoid tax, but only with the means they employ to do it."
52. *Parker's Case, op. cit.*, p.415.
53. *Mangin's Case, op. cit.*, p.842.
54. *FCT v Westgarth* (1950) 81 CLR 396.
55. *Ibid*, p.414.
56. *Denver Chemical Manufacturing Company v C of T* (NSW) (1949) 79 CLR 296. Quoted with approval by Fullagar, J. in *Australasian Jam Co. Ltd v FCT* (1953) 5 AITR 566 at p.573.
57. *Ibid*, p.313.

CHAPTER TWO

POSSIBLE CAUSES OF TAX EVASION AND TAX AVOIDANCE

2.1 INTRODUCTION

Only a limited number of empirical investigations into possible causes of tax evasion and avoidance have been carried out. Most of these have been conducted since 1970 and they have been carried out in countries other than Australia. Almost all have concentrated on tax evasion, and given the relative ease with which this term can be defined, the emphasis on this aspect of taxpayer behaviour is understandable. Much of the published research which has been done is reviewed in this chapter so as to develop a set of hypotheses which can then be tested against Australian data. As well as recent empirical work, the findings of certain government enquiries will also be considered to see whether some of the possible causes and effects of tax evasion and avoidance can be determined.

In this literature review there are at least two inherent problems, the first of which is that of definition of the two terms. In Chapter One it was shown that, although both result in less tax being payable than would otherwise be the case, evasion achieves this by means which are outside the law. Avoidance on the other hand involves taxpayers taking steps to prevent a liability from falling on themselves, or taking steps which cause lesser liabilities to fall. The difficulty with tax avoidance is that some of the means by which liabilities are avoided are against the spirit of the law while others are not. Acknowledgement of these two types of avoidance raises the question of how one is to

distinguish between them. In this chapter it is only "evasion" and "avoidance which a tax system ought to prevent" which are of most concern. Avoidance of this latter type differs little from evasion and is likely to have only temporary legal status.

The other problem is that there is a lack of consistency between different empirical studies. In particular they seem to mix three things, namely taxpayers' *attitudes* towards tax offences, taxpayers' *opportunities* to evade or avoid taxes and taxpayers' *reasons* for avoiding or evading tax. When considering reforms to prevent evasion or avoidance a clear distinction is required, particularly between the latter two. The purpose of this chapter, and that of Chapter Three, is to determine possible causes of tax evasion and avoidance. In doing so it is proposed to distinguish factors which might motivate taxpayers to evade or avoid from those things which merely provide them with the opportunity to do so. The format of the analysis here will follow that of Chapter One.

2.2 INCOME TAX IN THE UNITED KINGDOM FROM 1799

Statements made before the Hume Committee 1851 provided the first evidence of why taxpayers in the United Kingdom might have wanted to evade income tax. One general opinion put before the Committee was "that since income tax was intrinsically unfair, taxpayers were bound to try to evade it".¹ This opinion seems to derive from the circumstances which surrounded the introduction of the tax in the United Kingdom. Essentially, tax on income was seen as a war tax and, in times of peace, there was little public support for it:

The tax was, nevertheless, only impatiently endured until the conclusion of the war, and was then again wholly repealed in obedience to a singularly emphatic expression of the

popular will ... The function of the Income Tax was thus, down to 1815, declared to be the raising of funds for the war, and that alone. Its position was clearly defined as that of a fiscal expedient temporarily added to the tax list for this purpose. ²

Income tax in its early days in the United Kingdom was tolerated because it was seen as a necessary imposition to finance war expenditures. This was seen to be *the* purpose of the tax because this, the people were promised, was *the* purpose of the tax. It is understandable that, in the absence of any war, dissatisfaction arose on its reintroduction in 1842. Nowadays, income tax has become firmly entrenched as a government revenue raising device and this causal factor should no longer be relevant. At least, if income tax is widely regarded as being "intrinsically unfair" it should be for other reasons.

Before the Hubbard Committee (1861) it was said that "inequity produced evasion ... that revision by differentiation would ensure the automatic disappearance of evasion." ³ The perceived inequity was the taxation of *earned income* (i.e. personal exertion income) and *unearned income* (i.e. property income) at the same rate. At the time, the view was held that because unearned income required no personal effort and because it was likely to be more permanent it ought to be taxed at a higher rate.

Inadequate book-keeping by some traders was also alleged to have contributed to evasion of tax in those early days:

But the greater number of the sufferers [of an over assessment] do not keep their accounts in such good order as would admit of their preparing a three years' summary at short notice. Many retail cash traders of the smaller sort keep no account at all. ⁴

However it is unclear whether inadequate book-keeping simply created the opportunity for evasion or was a cunning device for perpetrating tax frauds. Just before the turn of the century another motivating factor was perceived:

There is also the undoubted fact that some of the evils of the tax are considerably lessened when the rate is low. A nominal rate of two pence in the £ would certainly not present so great an inducement to evasion as the higher rates of recent years.⁵

Although the "higher" rates cited by the author were rates of only seven pence in the pound it suggests that economic factors were important. The higher the rates of tax the more likely evasion. Perhaps a better statement of the position would be in terms of taxpayers' perceptions of the tax rates and their perceptions of the rate of increase in taxes. But the point remains that even before the twentieth century 'high' tax rates were seen as a positive inducement to evasion.

It was also considered that ineffective administration by the revenue authorities contributed to successful evasion. The view was expressed that "no type of direct tax system could succeed with amateur interest and only an intrinsically amateur organisation".⁶ But cries from the Board of Inland Revenue, in the last decades of the nineteenth century, for more resources and increased powers were not heard with much sympathy. Government revenue was not heavily dependent upon income tax⁷ and the granting of increased powers to bodies such as the Board of Inland Revenue was contrary to government thinking at the time.

Witnesses before the Ritchie Committee (1906) agreed that the penalties imposed upon tax evaders were ineffective as a deterrent. Though it was not suggested that inadequate penalties stimulated evasion, rather that such penalties did not act as a deterrent. Other evidence

before the Committee indicated that avoidance of excess profits duties had but one causal factor, namely, the high rate at which that tax was imposed.

2.3 FINDINGS OF THE RADCLIFFE AND CARTER COMMISSIONS AND THE ASPREY COMMITTEE

2.3.1 The Radcliffe Commission

High rates of tax and inadequate means of detection were influences on the level of avoidance and evasion stressed by the Radcliffe Commission:

Avoidance of tax is a problem that faces every tax system and is likely to continue to do so when rates of tax are high and the burden of tax is seen to have a major influence upon the affairs of business and upon every aspect of social and personal life. ⁸

and

An adequate supply of well trained staff is probably the most effective single instrument of the Revenue in reducing evasion of tax. ⁹

The first extract suggests that high tax rates motivate taxpayers to avoid whereas the second suggests that ineffective administration provides a conducive environment for those who have decided to evade to do so. While inadequate staff may contribute to evasion too much emphasis should not be placed on this. The fact that it was emphasised may simply reflect that the bulk of information on evasion came to the Commission from the Board of Inland Revenue who may have had other motives for the content of their submissions. Valuable insights into the possible causes of tax avoidance and tax evasion come from another part of the Radcliffe Commission's Report: the Memorandum of Dissent. The minority recognised a number of possible causes of tax avoidance and evasion:

The incentive to make such adjustments ... is in direct proportion to the effective marginal rates of tax and is inevitably powerful at the present level of taxation.¹⁰

... we feel impelled ... to record unequivocally our view that the existence of widespread tax avoidance is evidence that the system, not the taxpayer, stands in need of radical reform.¹¹

Our present schedule of rates ... tends to take account of the fact that the tax base lags increasingly behind true taxable capacity as we move up the income scale - just as in some other countries, where tax evasion is prevalent, evasion leads to higher nominal rates which in turn leads to further evasion and still higher rates.¹²

Further reading of the minority report reveals that the tax system itself was seen as providing the opportunity as opposed to the motivating factor for avoidance.¹³ In particular, the exemption from tax of capital gains was seen as the most serious defect of the system. The above supports the majority view that the dominant motivating factor for avoidance and evasion was the high level of taxes.

2.3.2 The Carter Commission

The Carter Commission outlined five specific reasons for which the practice of tax avoidance deserved condemnation yet only scant attention was paid to possible reasons why taxpayers wished to avoid tax. The heavy burden of taxes appeared to be the only reason offered as a motivating factor:

The propensity of taxpayers to avoid tax probably tends to follow tax rates, and with the rates of tax as high as they are to-day [1966], the temptation is strong. Tax avoidance probably came into its own during World War II and in the post war period when the rates were sufficiently high to make the tax savings outweigh the expense and inconvenience of tax avoidance measures ...¹⁴

Problems with the tax system were seen as providing an opportunity for particular avoidance schemes and in this respect the Carter Commission

concurs with the minority view expressed in the Radcliffe Commission's Report:

It is our view that the adoption of the comprehensive tax base we recommend would greatly improve taxpayer equity by bringing virtually all increases in economic power into tax. Such a tax base would also have the very desirable ancillary benefit of substantially eliminating the uncertainty, and the various opportunities for tax minimisation and avoidance. ¹⁵

Taxation of capital gains was also the most fundamental change considered necessary to widen the Canadian tax base and improve equity. This was also the view of the minority of the Radcliffe Commission on the United Kingdom's tax system.

2.3.3 The Asprey Committee

As with the reports of the two Royal Commissions the Asprey Committee's Report provides only brief insights into the possible causes of tax evasion and avoidance. Once again though, the chief motivating factor was seen to be the high level of taxes:

What it is possible to be rather more certain about is the encouragement high marginal rates of income tax give to avoidance and evasion. ¹⁶

and

... while evasion will always be a problem for tax administration, the problems can be expected to be more severe the lower the willingness of the public to accept that the tax system is a fair and equitable one. ¹⁷

Although the latter quote suggests a second causal factor, namely perceptions of fairness of the tax system, further reading of the same paragraph indicates that, in the Committee's view, taxpayers judge whether a system is fair and equitable mainly in terms of the burden of tax: "Except in special situations such as wartime, a high burden of income tax is unlikely to be favourably received by the population

at large."¹⁸ Emphasis by the Asprey Committee on the "high burden" of taxes more likely suggests that both high marginal rates, which receive special mention, *and* high average rates of tax are both influential.

2.4 A REVIEW OF RECENT RESEARCH INTO POSSIBLE CAUSES OF TAX EVASION AND TAX AVOIDANCE

2.4.1 Schmolders (1970)

Schmolders' study¹⁹ was based on large samples ($n > 1000$) in Great Britain, France, Spain and Italy and was conducted to find out more about taxpayer mentality, taxpayer tension feelings and taxpayer morale. Results of the survey were combined with results from earlier studies in Germany and with a critical evaluation of enforcement techniques in all five countries. It was found that where the control system was very weak it resulted in a deterioration of taxpayer attitudes, sometimes to a "grotesque degree". When this happened the tax system did not achieve its goals because taxpayer non-compliance was very high. On the other hand it was also found that if the control system was too tight it achieved its goals only at the expense of heavy confrontation with taxpayers. This confrontation could, over time, lead to general taxpayer resistance. These findings can be combined to suggest a relationship between enforcement activities and taxpayers' willingness to co-operate similar to that in Figure 2.1.

Implied from this representation is the need to balance tax enforcement techniques and co-operation with taxpayers. Schmolders' work on the intensity of confrontation indicated that greater fear of being caught might increase taxpayers' willingness to comply on the one hand but it might also reduce their co-operation on the other. The

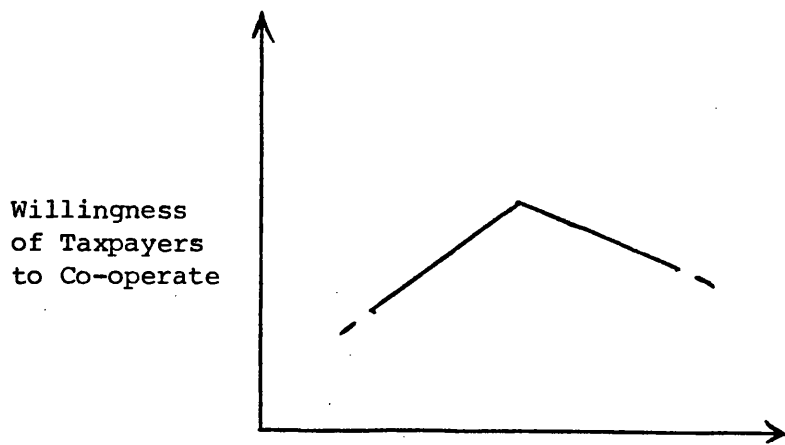


FIGURE 2.1: Tightness of the Control System

precise effect of increased confrontation with taxpayers (for example, tighter controls through more investigations) might cause some taxpayers to comply rather than evade and it might cause others to evade rather than comply. For instance, it was found that both the West German and British tax systems were effective but for different reasons. Intensive controls in the German system resulted in lack of co-operation especially by the self-employed. In the British system a more cautious assessment procedure operated with the result of greater co-operation by taxpayers. However, there are limits to the amount of slack that should be allowed to develop in a tax system. Tax systems in countries such as Italy, Spain and France, which had very weak control systems, also had very little compliance. Maximum willingness of taxpayers to co-operate is achieved at something less than "a very tight" control system.

Schmolders points out that "tax enforcement is a behavioural problem and any success depends upon co-operation; this means not so much individuals but group co-operation. Tax administration can make up for individual tax resistance but not for the hostility of the group or of everybody concerned."²⁰ He also suggests that opportunity for evasion is higher where a large proportion of the population is engaged in agriculture or in small trading. Where a large proportion of the

population are wage and salary earners, particularly where they are employed by large firms or government agencies, evasion is likely to be less.

2.4.2 Allingham and Sandmo (1972)

Allingham and Sandmo's findings²¹ are based on a *theoretical analysis* the objective of which was that of analysing the individual taxpayer's decision on whether to evade taxes by deliberate under-reporting. They consider both the simple static case and the dynamic case where individuals are required to make a sequence of tax declaration decisions. Their models are based on the Von Neuman-Morgenstern axiom for behaviour under uncertainty²² where taxpayers structure their decisions according to the following equation:

$$E(U) = (1 - p) U(W - QX) + pU[W - QX - \pi(W - X)]$$

where

- U = cardinal utility
- p = probability of investigation
- W = actual income (known only to the taxpayer)
- Q = tax rate
- X = declared income
- π = penalty rate (π is assumed > 0)

According to Allingham and Sandmo actual income (W) is exogenously determined and known, for the time being, only by the taxpayer. The taxpayer will choose to report a level of income (X) that will maximise the expected value of his utility. The taxpayers decision variable then is X and the value of X is influenced by the probability of detection (p), the tax rate (Q) and the penalty rate (π).

One thing the static model suggested was that taxpayers would under report their income where "the expected tax payment" on undeclared

income was less than the regular rate, i.e. where $\pi < Q$. Analysis of the dynamic model did not alter the range of factors influencing taxpayers' decisions. The only difference was that taxpayers' decisions to maximise were based on lifetime utility $[\sum_1^{\infty} E(U_t)]$. That is, the dynamic model takes into consideration the fact that if a taxpayer was discovered cheating in " t_n " and was investigated it might also mean that he would also be discovered for cheating in " $t_n - 1$, $t_n - 2$, etc".

Allingham and Sandmo's model has been developed in different ways by various writers²³ including Mork (1975) who found that "there was a steady decline in income reported to tax authorities as a proportion of income stated in the interview"²⁴ i.e. the greater the proportion of income withheld the higher true income is. Although it is suggested that evasion is positively related to true income it does not suggest any new motivating factors.

Norsworthy (1966) had also developed a theoretical analysis of taxpayer behaviour which alleged that evasion of the personal income tax was based on utility maximisation.²⁵ The theory, based on a number of simplifying assumptions, was also one of individual taxpayer behaviour. Yet empirical verification of the hypotheses was made using data, aggregated for classes of taxpayers, stratified by either level or source of income. Both mathematical and graphical models were presented showing optimal strategies for individuals. Graphically the individuals' marginal adjustment of the rate of concealment of income was that shown in Figure 2.2,²⁶ where

- M = marginal utility of the income level (Y)
- MEL = marginal expected loss
- tm(Y) = marginal utility of the tax liability of the concealed dollar of income.

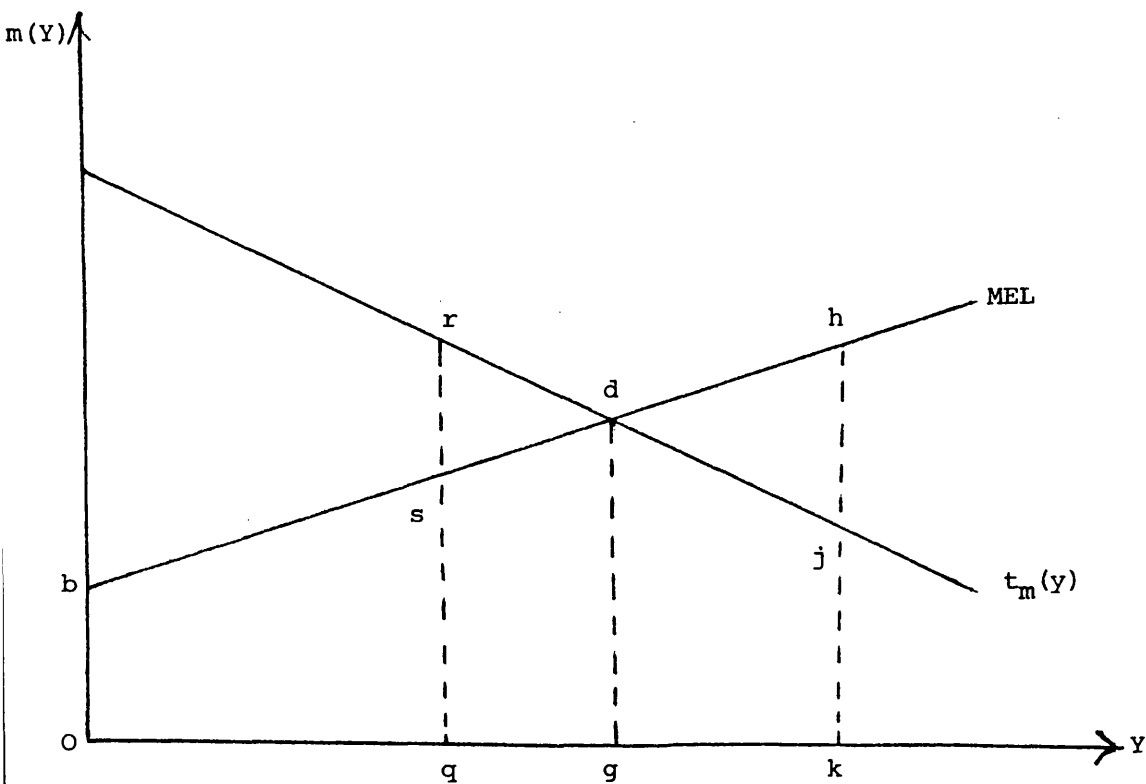


Figure 2.2: Individuals Marginal Adjustment of the Rate of Concealment of Income.

Source: J.R. Norsworthy, "A Theory of Taxpayer Behaviour: Evasion of the Personal Income Tax", Univ. of Virginia Ph.D., 1966, at p.16.

[N.B. The above assumes a constant rate of tax.]

Figure 2.2 depicts O_g as the equilibrium rate of concealment, where the marginal gain is equal to the marginal expected loss. Below O_g there is a marginal net gain from further evasions and beyond O_g there is a marginal net loss from further evasions. Although this analysis assumes a constant tax rate Norsworthy relaxes this assumption to allow consideration of progressive and discontinuous rates. In these instances multiple evasion equilibria are possible and the rational, utility maximising individual will select the equilibrium of the highest level of income concealment. The theory presented by Norsworthy suggested "taxpayer sensitivity to the marginal tax rate on income, probability of audit, and penalty for tax evasion."²⁷

2.4.3 Vogel (1974)

One of the most intensive and extensive empirical surveys was that conducted by Vogel.²⁸ Over 200 questions were asked of 1796 Swedish taxpayers by way of hour long personal interviews. Among other things it was hoped to ascertain the determinants of taxpayer attitudes and tax evasion. The study postulated three determinants:

- (i) *the exchange indicator* - which was calculated from individual tax burdens compared with governmental services received;
- (ii) *the social orientation indicator* - which was determined by classification of respondents by social class and by knowledge of the tax system; and
- (iii) *the illegal opportunity indicator* - which was based on respondents own estimates of their chances of successful evasion.

On the basis of the data collected a typology was developed to establish a deeper understanding of the motivational bases of behaviour. Three

deviant types of behaviour were distinguished:

- *deviant internalisation*. This type saw the tax system as unfair and internalised this perception into deviant behaviour.
- *deviant identification*. This type saw the tax system as fair but questioned the legitimacy of the laws and regulations.
- *deviant compliance*. This type accepted the legitimacy of the laws and regulations but decided to evade taxes because of group pressure.

However, of these three types only *deviant internalisation* was found to be significant. Closer analysis of the data by income level indicated that deviant internalisation was twice as common for taxpayers earning 40,000 Kronor a year as it was for those earning 20,000 Kronor a year. One possible reason for this was suggested from the relationship of income with the exchange indicator. It was found that those with higher incomes generally perceived their exchange rate was less favourable than those with lower incomes.

Another statistically significant finding from this study was that "group support forms a deviant sub-culture within the larger dominant culture."²⁹ Group support included the transmission of deviant norms, techniques of evasion and techniques of neutralising deviant behaviour to keep up a positive self conception. As well as suggesting possible motivating factors Vogel also sought to determine factors which provided the opportunity to taxpayers who wished to evade:

... in my opinion, tax evasion goes back to the built-in opportunities available in the Swedish tax system and its collecting practices. Legal complexity itself and the amount of data to be checked facilitate tax evasion.³⁰

Vogel found that illegal opportunity was greater for self-employed than for employed and also that it was greater where income was not taxed at its source. Both opportunity to evade and motivation to evade must co-exist; for all the motivation in the world will not matter unless the opportunity also exists.

2.4.4 Spicer and Lundstedt (1976)

Spicer and Lundstedt's study³¹ was conducted in the United States in 1974 and sought to determine factors influencing taxpayer attitudes and taxpayer behaviour. They used a survey questionnaire but believed that the survey design they used and a pretest assured them of a "fairly high degree of face validity".³² Questions used in the survey had been pretested and selected from a larger inventory of questions by factor-analysis. Responses to the main questions relating to hypotheses were scored on a Likert type scale and questions were also asked to determine the background characteristics of respondents. Of concern to the researchers was the problem of eliciting honest responses. They felt, however, that responses which were guaranteed complete confidentiality and which related directly to individuals own propensity to evade could produce reliable results. They could, provided respondents were given "a scale which differentiates between moderate and extreme rejection of [evasion]".³³ They concluded that "while any individual response on items or questions may not quite honestly reflect his own orientation towards the commission of tax evasion, it is reasonable to assume that variations in responses across respondents should correspond fairly closely to variations in the true propensity of individuals to evade taxes."³⁴

Spicer and Lundstedt viewed the taxpayer/government relationship as containing three elements: an element of coercion, an exchange relationship, and an internalisation of norms. The first element was tested by two hypotheses: that evasion is likely to be less when sanctions are perceived to be severe and that evasion is also likely to be less when the probability of detection is perceived to be high. The second element was tested with the hypothesis that evasion is more likely when a taxpayer perceives his terms of trade, *vis a vis* other taxpayers, with the government is inequitable. The final element was tested with the hypothesis that the more tax evaders a taxpayer knows, the more likely he is to evade taxes.

Spicer and Lundstedt attempted to determine factors affecting *tax resistance*, or propensity to evade taxes, as well as tax evasion itself. ³⁵ Their hypotheses were also tested against a number of background variables and the following results were found:

- (i) *Tax resistance* was found to be positively related to perceptions of inequity, number of evaders known and the probability of detection. However there was no significant relationship with the perceived severity of sanctions. The most important background variable was age, with increasing age being positively related to lower resistance; and
- (ii) *Tax evasion* was found to be positively related to perceptions of equity and number of evaders known but there was no significant relationship between evasion and probability of detection. The most important background variable was experience taxpayers had had with tax audits, with a positive relationship between evasion and experience with tax audits.

Spicer and Lundstedt also used open ended questions to determine what aspects of the exchange process caused taxpayers to perceive their

terms of trade as being unfair: "of those who thought the distribution [of tax burdens] to be not too fair, unfair, or very unfair, 75 per cent stated that a major reason was extensive tax avoidance by affluent taxpayers or corporations."³⁶

In a further study Spicer and Becker (1981)³⁷ sought, by using an experimental approach, to examine the relationship between fiscal inequity and tax evasion. Specifically they wanted to test whether the amount of taxes evaded would increase for victims of fiscal inequity but decrease for beneficiaries of fiscal equity. Fifty-seven University students were recruited for the experiment which, they were told, would take the form of a tax game. For each of ten periods they would receive a salary, in respect of which they had to decide how much to declare for tax purposes. Random audits were conducted and fines imposed for under-reporting income. Participants were also given additional information about tax rates which was designed to stimulate perceptions of equity or inequity about the taxes they would pay. The information given was not the same in all cases but differed to see what influence it might have.

They found that participants on average evaded 23.13 per cent of total taxes payable. Evasion was higher among the group told they were paying higher taxes than the average. Spicer and Becker's results are reproduced below:³⁸

TABLE 2.1

Percentage of Tax Evaded, Analysed by
Perceived Relative Tax Rates

	<u>% of Tax Evaded</u>
"Low Tax" Group	12.26
"Medium Tax" Group	24.50
"High Tax" Group	32.63
All Groups	23.13

Though the researchers said their findings should be treated with caution they felt their hypotheses received support from the experimental results.

2.4.5 Dornstein (1976)

Dornstein's study,³⁹ based on a sample of about 2500 *self-employed* taxpayers in Israel, was designed to investigate some factors relating to conformity of taxpayers in Israel to income tax regulations. The population chosen for Dornstein's study was self-employed taxpayers and therefore excluded employees. It was considered that there would be little scope for evasion of this latter group because tax was deducted at source. A random sample of 4600 was obtained from a population of 130,000 and this sample was then reduced by excluding all taxpayers who were not liable for tax. Information was mainly gathered from individuals' tax files but other sources were used.

Significant relationships were found with the two main hypotheses that were tested, *viz.* that taxpayer conformity was positively related to his basic orientation towards norms and that it was also positively related to the control system. Taxpayers' basic orientation was shaped by a number of factors among which were their past and present socio-cultural experiences, their ideological predisposition towards the State, and their experience in dealing with bureaucratic and governmental institutions. Two factors were considered to influence the type of control system which operated: first, the penalties imposed for evasion and second, the amount and quality of control by the tax authorities. However, it was found that the relationship between control and compliance to tax regulations was complex: "on the one hand, where control is efficient and deviations are easily detectable, control encourages

conformity ... On the other hand, low efficiency of control may encourage 'covert' nonconformity and 'overt' conformity."⁴⁰

Dornstein stresses that taxpayer conformity is a compound concept which has several elements including ethnic background, length of time taxpayers had resided in the country and age. For instance, she found a significant inverse relationship between age and conformity which she said "was explained by the greater daring in dealing with tax authorities, as a consequence of greater experience with bureaucratic institutions."⁴¹

It is possible that Dornstein's findings have implications for Australia. According to a joint statement issued, on 14 September 1980, by the Commissioner of Taxation and the Secretary of the Department of Immigration and Ethnic Affairs, illegal immigrants were offered a regularisation of status program. From a tax view point such persons were advised:

No tax penalty will be imposed in any case where a taxpayer voluntarily lodges back-year returns and the tax assessed is found to be fully covered by the PAYE tax instalment credits due. In some cases, a tax refund may even be available.

and

It is a long standing practice of the Tax Office to treat leniently people who make voluntary disclosures of failure to comply with the tax law before departmental inquiries into their cases had begun.⁴²

Illegal immigrants might then be more likely to evade tax than persons born in Australia because they (the immigrants) could fear that lodgement of a return might expose them and lead to their deportation.

2.4.6 Frank and Dekeyser-Meulders (1977)

The methods used in this study to determine the level of tax

evasion were macroeconomic and consisted of comparisons of declared income for tax purposes with income statistics from national accounts and other sources. It involved the calculation of tax discrepancy coefficients which is the difference between taxes paid and tax which would have been paid if there had been no evasion. These coefficients only have meaning for taxpayers of a particular income bracket and social-professional group. In the study such coefficients were obtained for nine income classes and eleven socio-professional groups. Unfortunately to carry out the study a large number of data adjustments had to be made. It might also be noted that the technique used in this study could also be used to analyse other aspects of taxation, e.g. estimating the loss of revenue from tax evasion or from tax expenditures or concessions.

Frank and Dekeyser-Meulders⁴³ found that the "propensity to tax evasion varied according to income brackets and socio-professional groups".⁴⁴ Their study however was based on Belgium data and the results may be of significance in that country alone. It was found that the main source of evasion by certain socio-professional groups was in respect of income derived from investment in stocks and shares especially where they were held abroad. Only taxpayers in high income groups held such investments and opportunity for evasion was, generally, limited to them. Perhaps what the study reveals is that the opportunity to evade is related to the type of income derived and that the motivation to evade is related to the taxpayer's marginal rate of tax.

2.4.7 Criminal Investigation Division - U.S. Treasury (1978)

The Criminal Investigation Division of the U.S. Treasury has over recent years been compiling statistics on tax fraud "to determine the

extent of criminal tax fraud (tax evasion) and to determine the value of criminal investigatory activity."⁴⁵ The *Interim Report* which is based on the results of a number of individual district projects came to the following conclusions:

- (i) There is a close correlation between enforcement activities and compliance; where there is more enforcement there is more compliance.
- (ii) In the Special Enforcement Program there was a rapid decline or erosion in compliance where there was sporadic or termination of enforcement activities.
- (iii) While publicity of criminal investigation activity enhanced compliance, publicity without concomitant enforcement activity did not improve compliance.
- (iv) District projects were effective in encouraging and achieving voluntary compliance as well as spreading work loads. Taxpayers in small districts often tended to be closely knit and this often meant that investigation of one taxpayer resulted in voluntary compliance by others.
- (v) The apparent potential increase in recidivism for some taxpayers might indicate some systemic weakness which required remedy.
- (vi) Taxpayers once investigated tended to report additional tax in subsequent years. For taxpayers sentenced in 1972 the average additional tax reported, in years subsequent to the criminal investigation activity, was five times⁴⁶ larger than for all U.S. individual taxpayers.

It was suggested that recommendations for policy were clear. Tax laws must be enforced, enforcement activities must receive wide publicity and enforcement follow-ups must be carried out. Where the same taxpayers are found to be evading taxes or the same frauds are being committed, it

was suggested that the tax system itself might require reform. For example, in the Waterman Project (Baltimore District) it was found that improved book-keeping requirements and a different method of payment of income to the watermen (cheque rather than cash) increased compliance. Further, it was found that cost of the Federal grant required to provide training in record-keeping was more than offset by the increased tax collections. It was also found that occupational structures influenced taxpayers' propensity to bear the risk of detection. Hence, it was thought that attempts should be made to determine the propensities to evade of each group so that the marginal costs and marginal benefits of tax investigations of the groups could be determined. This would lead to improved cost effectiveness of tax fraud investigation work.

2.4.8 Song and Yarbrough (1978)

Song and Yarbrough's findings⁴⁷ were based on 287 questionnaires completed by persons who, in their respective households in a small city of North Carolina, normally prepared the income tax returns. These responses were obtained from a sample size of 640 randomly selected from a total population of 10,141 households. Taxpayers' attitudes towards their tax obligations as well as their behaviour (or compliance) with tax laws were explored. Though both aspects of their study are of interest it is the behavioural dimension which is most relevant here. They found that "the governing factor explaining people's tax compliance behaviour was the probability and subsequent fear of detection by law enforcement agencies."⁴⁸

Correlates to tax ethics (i.e. taxpayers' normative attitudes to their tax obligations) produced some significant associations. Among them income ($r = 0.36$) and education ($r = 0.26$) were the most strongly

related to tax ethics ($r = 0.36$). Song and Yarbrough also considered other variables such as whether the respondent had been audited, whether the audit experience was pleasant, and whether the respondent felt he received sufficient benefits from the tax he paid. None of these variables was found to be significantly related to tax ethics though it was felt that "tax auditing may affect compliance behaviour".⁴⁹ Unfortunately there was no elaboration on this latter point and it is uncertain whether the authors meant that tax audit experience would lead to an improvement or deterioration in taxpayer compliance behaviour. Of more concern was the fact that the survey was based on responses of a small North Carolina city (population approximately 34,000) and may not be representative of the whole population.

2.4.9 Lewis' Survey (1979)

As with Song and Yarbrough's survey this survey is limited in value because of the nature of the population frame. Lewis' survey population consisted of two hundred *male* taxpayers in Bath (U.K.), the population of which is approximately 90,000. Responses to questions were obtained with the assistance of four trained interviewers.

The survey carried out by Lewis attempted to assess "tax mentality" or attitudes of taxpayers to various taxation matters rather than motivation or propensity to evade.⁵⁰ However, his findings have implications for other studies outlined herein. Among the findings were first, "that attitudes to taxation are in part dependent on earnings";⁵¹ second, that "the 'exchange' model clearly does not explain all the data, attitudes to income tax are more complicated than this." In fact, it was felt that "the 'exchange' model of tax mentality was not a central part of respondents' cognitive field."⁵² Lewis also considered that the

'social orientation' model was inappropriate and that left him to conclude that tax mentality is probably based on something akin to self interest.

Some aspects of the methodology used in this study deserve comment. The attitude measure consisted of a five point Likert-type scale with "disagree strongly" at one end and "agree strongly" at the other. Though sixteen questions were asked only eight items were tested. Each item was tested with a question requiring a "favourable response" (or agreement) and an "unfavourable response" (or disagreement). "Each statement was paired in such a way that a consistent response would require favouring one of the pair and not the other (a negative correlation)."⁵³ It was found that in all cases there was a significant negative correlation but that overall respondents had a greater tendency to agree with statements rather than disagree. This serves as a warning for questionnaire design and for interpretation of results.

2.4.10 Dean, Keenan and Kenney's Survey (1979)

The survey by Dean, Keenan and Kenney found that "respondents cited factors such as personal economic considerations, the general level of taxation and its inequity as being in the forefront of reasons for people deciding to evade tax."⁵⁴ Taxpayers' feelings of inequity or their perceptions of an unfavourable exchange index were seen to depend first, on the high level of taxes, and second, on the belief that the Government (United Kingdom) did not spend taxpayers' money wisely.

2.4.11 Investigations in Australia into the Causes of Tax Evasion and Tax Avoidance

Most of the surveys reviewed in this part have been carried out

in the last ten years and none of these has been carried out in Australia. There is therefore little evidence, other than the conjectures of the Asprey Committee, on why taxpayers in Australia want to evade tax. Some research has been done in Australia on taxpayers' *attitudes* to the level of taxation, fairness of the tax system and to understatement of income. For instance, Kemp (1980) argued that the so-called "tax revolt really reflects declining trust and declining confidence in the government rather than specific problems with tax rates."⁵⁵ He based this argument on his own observations and on a poll conducted by the Roy Morgan Research Centre. Kemp noticed that high tax rates do not always lead to evasion. There have been instances where high tax rates have been tolerated, for example, during wartime. The poll referred to asked four questions by way of nationwide interview of 1100 men and women during the weekend 15-16 December 1979. Among the findings were:

- (i) That one in five approved, to some degree, of tax evasion by understating income.
- (ii) While a similar proportion was found in a 1972 interview (see Australian Sales Research Bureau, March 1972) the proportion then which strongly disapproved was 70% compared with 45% in the 1979 survey.
- (iii) It was felt therefore, that there was no strong relationship between believing that income levels were too high, or that the tax system was unfair. Rather it was considered that tolerance of evasion was related to negative attitudes to taxation itself.⁵⁶ It followed that a reduction in tax rates might not reduce the propensity of taxpayers to evade.

Apart from the Morgan Research Centre's poll little other empirical work has been done in Australia. There have, however, been several *opinions* expressed about things which might motivate taxpayers to avoid or evade tax. Recently one eminent Queens Counsel (Hulme, 1981)⁵⁷

added his opinion:

The success we achieve in effectively curbing tax avoidance will be directly influenced by the speed with which we achieve the goal of a taxation system which contains both greater equity and greater incentive. ⁵⁸

Hulme argues that fear, not greed, is the reason why *self-employed* taxpayers avoid tax. Fear that when age or illness brings their income earning life to an end they will not have enough funds put aside to provide for themselves and their families. He argues that if the tax system was fairer towards the self-employed they would be less likely to go in for tax avoidance. The two aspects of the tax system which he suggested ought to be remedied were (further) deductions for superannuation contributions and collection of tax by way of provisional tax. Hulme demonstrated that, in respect of superannuation provisions in the Act, self-employed taxpayers were disadvantaged and asked why this was so.

2.5 PROBABLE EFFECTS OF TAX EVASION AND AVOIDANCE

The first four parts of this chapter have attempted to find possible causes of tax evasion and avoidance. This has been done so that suggested reforms can be contemplated. However, before embarking upon reforms it is also necessary to consider the probable effects of tax evasion and avoidance. If the effects are negligible it would be unwise to embark upon reforms which might be costly to implement and have far reaching effects. On the other hand if many reforms must be undertaken then those reforms which are likely to be most beneficial should be undertaken first. In this part of this chapter it is proposed to outline some of the probable effects of tax evasion and avoidance.

2.5.1 Direct Effects of Tax Evasion and Avoidance

By definition one effect of tax evasion and avoidance is loss of revenue for those seeking to impose the tax. Estimates of the extent of tax evasion and avoidance, in Australia, vary considerably. For instance, the Institute of Public Affairs was reported to have said that total income involved in the tax avoidance industry and the cash economy amounted to some \$11,000 million a year.⁵⁹ In respect of lost tax revenue, one member of Parliament is reported as saying that "tax evasion varied from a Federal Government acknowledgement of \$1000 million to other sources' figures of up to \$7000 million."⁶⁰ It is probable that reference in the quote to Government estimates is based on data supplied by the Commissioner of Taxation in his annual reports. But when this is studied closely it reveals that the estimate of \$1000 million refers only to tax avoidance and then only to those schemes under administrative challenge. Schemes which have resulted in avoidance of tax and which have not come to the attention of the Commissioner of Taxation have not been included in these estimates. The *60th Report* of the Commissioner of Taxation expresses further alarm because the Taxation Office has not been able to record any significant improvement in compliance behaviour.⁶¹

In regard to estimates of tax evasion the Report states:

Enforcement programmes to detect income tax evasion and fraud continued to be carried out during the 1980-81 year in the form of investigations, field audits and internal check processes. The increase in tax assessed and additional (penalty) tax arising from these activities totalled \$167.7m.

While available statistics do not permit the extent of tax evasion to be quantified, it can be said that results from enforcement activities provide no indication that evasion is decreasing. Sadly, the reverse would appear to be the case. Research is continuing into ways and means of systematically measuring the level of non-compliance in the community.⁶²

Answers given recently, by the Treasurer, to questions asked in Parliament reveal further tax avoidance and evasion.

- (1) A separate record of claims for deductions under tax avoidance arrangements against which the Government has taken action was not kept in respect of the income years 1975-76 and 1976-77.

Identified claims by individual and company taxpayers for such deductions in respect of the 1977-78 income year amounted to about \$2,100m. A further \$660m was claimed in returns for the 1978-79 income year. Comparable figures are not yet available for the 1979-80 income year. Returns for that year are still being received and processed.

- (2) On the assumption that the taxpayers concerned derived enough income in relevant years to fully absorb the deductions claimed it is estimated that the revenue loss, if the 1977-78 and 1978-79 claims were allowed, would be in the vicinity of \$1,300m. ⁶³

Answers to other questions also reveal another direct effect of tax evasion - *viz.* shifting the burden of tax from those who evade to those who do not:

I think it must be accepted that tax evasion resulting from unrecorded transactions that go to make up the 'cash' or 'underground' economy has a bearing on the rates of income tax. The taxation laws are, of course, designed to raise a substantial portion of the revenue necessary to meet essential Government expenditure. As a general proposition, therefore, indulgence by some sections of the community in tax evasion practices, whether through participation in the cash economy or not, would increase the taxation burden borne by the general body of taxpayers who comply with the revenue laws. ⁶⁴

This latter effect is not confined to tax evasion practices. It also results from tax avoidance as the Asprey Committee, considering one tax avoidance practice, noted:

Generally speaking, as salaries and wages cannot be made the subject of income splitting, the opportunity by that means to order one's affairs so as to reduce the amount of tax otherwise payable is not equally available to all taxpayers. This is inequitable to the taxpayers who do not have that opportunity. ⁶⁵

The Asprey Committee was not the first to observe this effect. The Radcliffe and Carter Commissions emphasised the inequities between taxpayers which tax avoidance caused. The Radcliffe Commission saw tax avoidance as defeating the final purpose of the tax system; that purpose was the assessment of each person upon his true income.⁶⁶

Mathews has also stressed the inequity that results from tax avoidance and evasion:

In addition to eroding the revenue base and threatening the stability of the whole tax system, tax avoidance and evasion have radically changed the distribution of the tax burden between wage and salary earners and other income recipients on the one hand and between different income classes - rich and poor - on the other.⁶⁷

He showed that the tax paid by wage and salary earners as a percentage of total tax paid by individuals has increased significantly since the mid-sixties. In 1965-66 wage and salary earners paid 67% of the tax paid by individuals but in 1978-79 it had risen to over 81%.⁶⁸ While this could have been due to rising incomes of wage and salary earners, relative to other taxpayers, it could also have been due to tax evasion and/or tax avoidance by the "other income recipients".

Vinberg outlined a number of probable interconnected effects of undue concentration of effort on tax considerations:⁶⁹

- (i) It might impair economic activity - what might be good for the individual, viewed in an after tax sense, might not be good for society.
- (ii) It might result in expensive litigation.
- (iii) A spate of tax cases might unduly clog the legal system.
- (iv) It might result in additional legislation. This takes time and resources of the legislature and, over time, makes tax laws more complex and incomprehensible.

- (v) Because the benefits of particular tax avoidance schemes might only be transitory, further legal manipulations might soon be required with the result that the taxpayer, his customers, clients and business associates become confused in their business dealings with one another.
- (vi) It might misdirect the careers of some young professionals. The experience Vinberg cited was that of young lawyers viewing tax office experience as postgraduate training for later service in the tax avoidance industry.

From a revenue authority's point of view other direct costs would include the cost of detecting avoidance and evasion and the cost of considering reform proposals to prevent them. From a taxpayer's point of view Sandford summarises the direct costs. These include the time and enterprise of the taxpayer and the skilled manpower and costs to implement the scheme.⁷⁰

2.5.2 Indirect Effects of Tax Evasion and Avoidance

Sandford saw the effects (or costs) of tax avoidance as falling into three categories: "the resources taken up with tax avoidance work, including those required to implement any particular scheme; second, economic costs to society as a result of the implementation of avoidance schemes; third, a group of psychic costs."⁷¹ The second two categories are examples of indirect effects of avoidance and evasion. When the tax avoidance scheme has been implemented, if all has gone well for the tax avoider, his after tax return should have increased. But the way in which he is now running his affairs may involve a more wasteful use of resources from the point of view of society.⁷² The biggest psychic cost from tax avoidance arises from the narrowing of the tax base. Tax avoidance narrows the tax base and increases inequities between taxpayers.

Perceptions of these results by non-avoiders lead to resentment and unhappiness. If tax avoidance also leads to high tax rates then the psychic costs will further increase. The minority report of the Radcliffe Commission also emphasised these considerations.⁷³

Where evasion is widespread the possible economic and social costs in some countries can be quite severe. The reluctance of tax evaders to bring "black money" into circulation in Ceylon in 1965 threatened general economic stability. This resulted in a *tax amnesty*⁷⁴ because:

there was a general feeling, before the amnesty, that trade and business were grinding to a halt and that one factor in this trend was that a lot of capital owned by tax evaders was idle as they dared not use it in business ventures for fear of providing evidence for the Tax Department of wealth for which they could not legitimately account.⁷⁵

Gopal found that similar effects were evident in India, but one must be wary of using examples from underdeveloped countries such as India and Ceylon.

Vogel prefaced the conclusions of his study with the warning that any statements regarding the causes and effects of tax avoidance and evasion must be somewhat speculative. However, he distinguished primary evasion from secondary evasion and said that whatever the causes of primary evasion the internalisation of group norms can lead to secondary evasion.⁷⁶ Thus one of the effects of (primary) evasion by some taxpayers was (secondary) evasion by others. Evasion within groups might, therefore, be infectious. This conclusion, although speculative, received support from Dornstein's work on compliance by self-employed taxpayers in Israel. Dornstein, however, approached the matter from a slightly different point of view. She saw that evasion often traditionally encouraged the taxation authorities to increase their control which worsened taxpayer

morale and this, in turn, increased the willingness of others to evade. More taxpayers became disoriented.⁷⁷ As well, the Carter Commission, in condemning tax avoidance, suggest that it might lead to tax evasion:

Indeed it may be said that the widespread practice of tax avoidance will lead to an increase in evasion. Taxpayers who have little opportunity to practice tax avoidance and see others using legal means to reduce their taxes are sorely tempted to adopt illegal methods to achieve the same result ...⁷⁸

One sociologist has suggested other probable effects of evasion which are equally worrying. Davies suggested that people seeking to evade tax "are potentially liable to end up breaking more serious legal or moral rules than those regulating taxation."⁷⁹ Davies supported this contention with a quote from Teresa's book *My Life with the Mafia*:

Doctors are big with the mob. They have so much buried money, money they don't report to the tax boys. They want that money to work for them but if they invest it legitimately the tax man will find out. So they invest it with the mob people. In Boston there were dozens of doctors who provide money to the mob guys for loan sharking ...⁸⁰

That is, *secondary crimes* not merely secondary evasion can arise out of primary evasion. These secondary crimes, cited by Davies, are however, carried out by *the same* taxpayer and not by others. As evasion becomes more widespread governments might seek greater legislative powers to combat it. If such powers were granted then, in the long run, Davies suggested that individuals' civil rights will suffer from "further encroachments of the State".⁸¹

Shenfield makes the further point that experience has shown that anti-avoidance legislation has infringed the rule of law.⁸² He argues that examples can be cited from experience in several countries where such legislation has either increased discretionary powers of particular officers or has operated retrospectively. Both of these infringed the

rule of law. Shenfield also argued that the idea of tax avoidance causing a shift of the tax burden *pro tanto* onto the shoulders of the non-avoider was too simplistic. He suggests that "tax rates are determined by other factors in addition to the presumed need for revenue and these factors are in general of more influence upon the outcome than avoidance."⁸³ This view is supported by Wildavsky who, from behavioural analysis of the budgetary process, found that the largest determining factor of the size and content of this year's budget was last year's budget.⁸⁴ Bracewell-Milnes also refused to accept the proposition that tax avoidance reduced overall revenue and continued:

Once it is recognised that the artificial avoider and evader ... are in general no less likely to increase tax revenue than to reduce it, the other dimensions of the question begin to fall into perspective. If the avoider and evader are not in general imposing burdens on the fisc or their fellows, the moral and political arguments against them lose much of their point.⁸⁵

In fact, if high rates of tax are a disincentive to work then "tax avoidance may benefit the fisc by maintaining the incentive to activity that would otherwise be frustrated by taxation."⁸⁶ That is, the alternative to untaxed economic activity might be leisure which could leave revenue authorities worse off. A summary of the probable effects of tax avoidance and evasion is given in Table 2.2.

2.6 SUMMARY OF FINDINGS

Of the empirical research on possible causes of taxpayers' deviant behaviour the two most influential studies, in terms of their rigour, are those of Vogel (1974) and Spicer and Lundstedt (1976). The hypotheses they tested and the results they achieved were similar and their work suggests three general hypotheses which can be tested against Australian

TABLE 2.2

Probable Effects (Costs) of Tax Evasion and Tax Avoidance

- (a) *Direct Effects*
- loss of revenue for the government
 - gain of revenue to individual avoiders or evaders (assuming their behaviour goes undetected)
 - redistribution of tax burdens with increasing burden on those who do not avoid or evade
 - time and skill of taxpayer and his advisers in undertaking these activities
 - costs incurred by taxpayers in implementing the necessary arrangements
 - time and costs to revenue authorities in attempting to combat these activities
- (b) *Indirect Costs*
- possible misallocation of resources from society's point of view
 - secondary avoidance and evasion by others
 - other crimes being carried out by evaders and avoiders
 - unnecessary complication of business affairs
 - possibility of legal system becoming clogged up in tax cases
 - misdirection of careers of young accountants and lawyers
 - worsening of taxpayer morale
 - possible narrowing of the tax base
 - increased complexity of the tax laws
 - possible erosion of civil rights and professional privilege
-

data. These hypotheses, their symptoms and research consistent with them are summarised in Table 2.3.

TABLE 2.3

Possible Causes of Tax Evasion

<u>Hypothesis</u>	<u>Symptom</u>	<u>Supported By</u>
(a) Exchange Relationship	(i) Perceptions that tax rates are too high.	1,2,5,8,11
	(ii) Perceptions that the tax system is unfair.	1,2,3,4,5,6,11,13
	(iii) Perceptions that the Government spends taxpayers' money unwisely.	4,11,12
(b) Social Orientation	(i) Basic predisposition to the State and the law in general.	4,7,12
	(ii) Influence of groups on individual behaviour, particularly the number of evaders known by the taxpayer.	3,4,6
(c) Administrative Control	(i) Tax administration too coercive - e.g. tax enforcement too oppressive or too obvious.	3,6,9
	(ii) Tax administration perceived to be ineffective.	1,3,10

Legend to Table 2.3

<i>Source</i>	<i>Work Summarised At</i>
1 Radcliffe Commission (1955)	2.3.1
2 Carter Commission (1966)	2.3.2
3 Schmolders, G. (1970)	2.4.1
4 Vogel, J. (1974)	2.4.3
5 Asprey Committee (1975)	2.3.3
6 Spicer, M.W. & Lundstedt, S.B. (1976)	2.4.4
7 Dornstein, M. (1976)	2.4.5
8 Frank, M. & Dekeyser-Meulders, D. (1977)	2.4.6
9 Song, Y. & Yarbrough, T.E. (1978)	2.4.8
10 Criminal Investigation Division U.S. Treasury (1978)	2.4.7
11 Dean, P., Keenan, T. & Kenney, F. (1979)	2.4.10
12 Kemp, D.A. (1980)	2.4.11
13 Hulme, S.E.K. (1981)	2.4.11

Some of the symptoms in Table 2.3 require explanation as they are not the only ones which could have been chosen. They were the author's own choice and were based on several considerations including:

- (i) a desire not to replicate exactly the work of others;
- (ii) the knowledge that not all elements of the hypotheses could be tested, and
- (iii) the results of a pilot survey which, with mixed success, had considered other symptoms. The pilot survey had a low response rate, 38%, and it was felt that the length of the pilot questionnaire - 10 foolscap pages - was partly responsible. The author hoped to improve the response rate in the main survey by limiting the number of questions asked. This led to a compromise between number of usable responses and amount of information obtained from each respondent.

When Spicer and Lundstedt and Dean *et al* considered the exchange relationship, they did so in terms of taxpayers' perceptions of their own tax burdens relative to others and whether these were fair or unfair. In the author's pilot survey several questions were asked to explore the exchange hypothesis. These included question 2 which is reproduced below:

	Much too High	A Little too High	About Right	A Little too Low	Much too Low
2. What do you think about the amount of income tax you pay compared with the amount:					
	(circle one number for each question)				
(a) you earn ?	1	2	3	4	5
(b) others, who earn about the <i>same</i> as you, pay ?	1	2	3	4	5
(c) others, who earn <i>a lot more</i> than you, pay ?	1	2	3	4	5
(d) others, who earn <i>a lot less</i> than you, pay ?	1	2	3	4	5

For both groups surveyed, the answers to each part were similar. That is, roughly the same proportion of evaders (or non-evaders respectively) answered "much too high", "a little too high" and so on to each of the four parts. A visual scan of returned questionnaires revealed why this might have been so. Respondents seemed to pick their answer to the first part (question 2(a)) and then circle the same number for each of the other three parts (questions 2(b)-(d)). This apparent problem in questionnaire design could have been overcome by asking four separate questions and spacing them throughout the questionnaire. But this would have added to overall questionnaire length when there was a desire to shorten it. It was decided, rightly or wrongly, to retain only the first part of the question (2(a)). Thus respondents were only asked to state whether they thought the amount of tax they paid COMPARED WITH the amount they earned was "much too high", "a little too high" and so on. This did more than ask them whether they felt taxes were too high. It asked them in considering their own tax burdens to compare them with the amount they earned. It was hoped that in doing so they might consider the other factors implied in questions 2(b)-(d). Just in case this question did not fully capture respondents' perceptions about the fairness or otherwise of the tax system the further question "how satisfied are you with income tax laws" was added. These laws cover both the rates of tax and the rules for determining taxpayers' taxable income. Taxpayers who felt that their tax burdens were too high would be expected to indicate dissatisfaction with the tax laws. The final questions and symptoms may have been deficient but they were based on considerable forethought.

It should also be emphasised that no one hypothesis was tested with a single question. At least two and usually more questions were

used each seeking to specify another element of each hypothesis. To ask questions about all possible or all likely elements would have made the questionnaire far too long and analysis far too complicated.

One possible problem in exploring the exchange relationship is that respondents might not be aware of the connection between tax rates and government spending. Another point of the pilot survey (question 9) sought to determine whether respondents could see this connection. Both evaders and non-evaders were asked what they thought would happen, in the long run, to the level of Federal Government services if income taxes were reduced. A majority in each group thought that the level of services would remain about the same - but did this demonstrate that respondents failed to connect taxes and services ? Some may have felt that the government might use remaining revenue more efficiently. Others may have thought that as income taxes were reduced other taxes would be increased. Alternatively, lower income taxes may have meant less avoidance and evasion and overall revenue might have been maintained. The latter could have been true of some responses from the evader group - more of whom thought that the level of government services would have increased rather than have decreased as income taxes were reduced. A more suitable question would have required a variety of assumptions none of which might have been understood. Alternatively several questions might have had to be asked. In the end it was decided to delete this question.

Also in the interests of abbreviating the questionnaire, the number of questions relating to the minor hypotheses was reduced. For example the question "how do you feel about the amount of influence Governments and Government departments have on your life ?" was omitted as a symptom of the social orientation hypothesis. In addition other aspects of the

hypothesis were not explored including analysis of responses to question 7 comparing attitudes to tax evasion and attitudes to other property crimes of similar magnitude.

The determinants of taxpayer attitudes (i.e. the motivating influences) are seen as containing three elements:

- (i) *The exchange element.* This is represented by a taxpayer's satisfaction or lack thereof with his terms of trade with the government. This covers a variety of matters including a taxpayer's perceptions of his tax burden in relation to others, the amount of tax he pays relative to benefits received, his perceptions of how 'wisely' the government spends taxpayers' money and the taxpayer's general attitude to private versus public spending.
- (ii) *The social orientation element.* This is represented by what an individual feels is good or bad and his norms which depend upon his social interaction. This element can also be affected by a variety of influences including a taxpayer's social class, his knowledge of the tax system, the number of deviant taxpayers known to him and his basic orientation to the State and its laws.
- (iii) *The administrative control element.* This can be divided into two parts. The first suggests that where tax enforcement activities are too oppressive it might achieve short run compliance but also might, in the long run, lead to non-compliance. The second part suggests that where the control system is perceived as being weak or ineffective it can facilitate tax evasion and avoidance.

The literature search undertaken in this chapter has also revealed specific systemic weaknesses which contribute to avoidance and evasion. These can be viewed as aspects of a tax system which provide the opportunity for tax evasion and avoidance. Addington, as early as 1803, recognised that there was scope for evasion whenever tax was not deducted "at source". His proposals in 1803 to extend the principle of deduction at source substantially increased the yield of income tax in the United Kingdom.⁸⁷ Inadequate book-keeping, notably by small traders, and insufficient trained staff employed by revenue authorities also, according to the Radcliffe

Commission, contributed to evasion of income tax in the United Kingdom in the postwar (WW2) years.⁸⁸

Vogel (1974) considered that the Swedish tax system and its collection practices provided taxpayers with the opportunity to evade. Frank and Dekeyser-Meulders (1977) exposed a similar problem in Belgium. They found that evasion was most widespread in one socio-professional group but this group also tended to derive a more than proportionate share of their income from securities held abroad. Where such income was not voluntarily declared by the taxpayer the tax system was inadequate to ensure tax was paid on it. As a result of cross-national comparisons, Schmolders (1970), found that where a large proportion of the population was engaged in agriculture or small trading evasion was more likely. Both of these situations were characterised by a low standard of book-keeping. More stringent book-keeping requirements similar to those self imposed by large firms or government agencies were likely to result in less evasion.

Witnesses before the Ritchie Committee (1851) exposed inadequate penalties as providing a favourable environment for evasion. Over one hundred years later, Dornstein (1976), supported the view that taxpayer compliance was related to various aspects of the control system including the amount and quality of enforcement activities of the tax authorities. Spicer and Lundstedt (1976) made a sharp distinction between the effectiveness of penalties for evasion and the probability of detection. They found that only the latter was significantly related to taxpayer resistance.

Vogel also found that evasion is higher amongst self-employed taxpayers than it is with those taxpayers who are employees. Once again the opportunity to evade exists with the self-employed to a greater degree.

Employees would normally require collusion with employers to evade as tax instalments for wages and salaries are deducted at source in most countries. It ought to be pointed out that the distinction between the two classes - "employed" and "self-employed" - is not altogether clear. In fact it is quite possible for some taxpayers to be members of both groups. There is no reason why a carpenter employed by a builder during the week could not become self-employed at the weekend. That person has greater opportunity to evade tax on payments for weekend work than he has in respect of payments for work he does during the week.

The tax system itself was seen, by the members of the Radcliffe Commission submitting the minority report, as providing a favourable environment for tax avoidance in the United Kingdom. Absence of a tax on capital gains was seen as the most notable defect. This same defect was seen by the Carter Commission as influencing tax avoidance in Canada. The Meade Committee (1978) suggested that the income tax system itself (if retained) might require further reform to reduce avoidance. They suggested that avoidance, under an income tax regime, could be reduced if tax were imposed under a single rate structure.⁸⁹ It seems then that as well as enquiring into taxpayers' motives for avoiding or evading tax an enquiry ought to be made into the tax system itself to see whether it contributes by providing *opportunities* for evasion and avoidance. Possible headings under which this enquiry could be made are summarised in Table 2.4.

The Australian tax system is evaluated in terms of this structure in Chapters Three and Four. Thereafter, in Chapters Five and Six, results are given of two nationwide surveys conducted to determine what might have motivated Australian taxpayers to evade and/or avoid tax.

TABLE 2.4

Aspects of a Tax System which could facilitate Tax
Evasion and Tax Avoidance

- (a) *Tax Evasion*
 - adequacy of tax collection procedures
 - adequacy of book-keeping requirements
 - adequacy of resources used to detect evasion
 - adequacy of the penalty structure
 - adequacy of various administrative procedures.
- (b) *Tax Avoidance*
 - opportunity to split income
 - opportunity to convert income into capital
 - exemptions from the tax base
 - adequacy of anti-avoidance provisions.

FOOTNOTES TO CHAPTER TWO

1. Sabine, B.E.V., *A History of Income Tax*, London: George Allen and Unwin Ltd, 1966, p.25.
2. Blunden, G.H., "The Position and Function of the Income Tax in the British Fiscal System", *The Economic Journal* No.2, 1892, pp.637-8.
3. Sabine, B.E.V., *A History of Income Tax*, *op. cit.*, at p.179.
4. Blunden, G.H., *op. cit.*
5. *Ibid*, p.651.
6. Sabine, B.E.V., *op. cit.*, p.17.
7. Less than 5% of total revenue was received from income tax.
8. *Royal Commission on the Taxation of Profits and Income*, Final Report, Cmd 9474, London: HMSO 1955, at para. 1015.
9. *Ibid*, para. 1072.
10. *Ibid*, para. 22 of the *Memorandum of Dissent*.
11. *Ibid*, para. 33.
12. *Ibid*, para. 218.
13. *Ibid*, see in particular para. 34 and part 45.
14. *Report of the Royal Commission on Taxation*, 1966. Ottawa, Canada: Queens Printer and Controller of Stationery, at p.103.
15. *Ibid*, p.71.
16. *Taxation Review Committee - Full Report*. Canberra: Australian Government Publishing Service, 1975, at para. 14.31.
17. *Ibid*, para. 14.32.
18. *Ibid*, para. 14.32.
19. Schmolders, G., "Survey Research in Public Finance: A Behavioural Approach to Fiscal Policy", *Public Finance*, 1970, pp.300-306.
20. *Ibid*, p.305.
21. Allingham, M.G. and Sandmo, A., "Income Tax Evasion: A Theoretical Analysis", *Journal of Public Economics*, 1972, Vol.1, pp.323-338.
22. *Viz.* The taxpayers cardinal utility function has income as its only argument, this must be understood as the indirect utility function at constant prices. Marginal utility is assumed to be everywhere positive and strictly decreasing so that the individual is risk averse.

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CHAPTER THREE

OPPORTUNITIES FOR TAX EVASION IN THE AUSTRALIAN TAX SYSTEM

3.1 INTRODUCTION

In Chapter Two it was shown that the extent of tax evasion and avoidance was influenced both by a taxpayer's willingness to undertake those activities and the opportunities for those activities within a particular tax system. Until information is obtained from taxpayers themselves in a particular country little can be suggested, by way of reform, to reduce the desire of taxpayers to evade or avoid. If forced to suggest reforms experience from similar countries might be relevant though this might not be entirely satisfactory. In the meantime the tax system of a country can be analysed to see whether it provides taxpayers with scope for evasion and avoidance. In this chapter an analysis is made of the *Australian tax system* to determine whether it provides opportunities or scope for *tax evasion*. A similar analysis is made in Chapter Four, for tax avoidance. Though there is little hard evidence that tax evasion and avoidance result in a loss of welfare for society it must be conceded that a tax system itself should not be so designed as to provide opportunity for either activity. If there is scope for evasion and avoidance then those opportunities are unlikely to be equally available to all taxpayers. Where evasion and avoidance result there is a shift in the incidence of tax. The tax system then results in inequality. Robbins provides the classic statement on equality:

I do not believe and never have believed that in fact men are necessarily equal or should always be judged as such. But I do believe that, in most cases, political calculations which do not treat them as if they were equal are morally revolting. ¹

The analysis in the remainder of this chapter is preceded by a brief outline of income tax in Australia to provide the necessary background.

3.2 THE AUSTRALIAN TAX SYSTEM

On Federation s.51(ii) of *The Commonwealth of Australia Constitution Act* 1900 gave the Commonwealth power to make laws with respect to taxation. Those laws, to be valid, could not however discriminate between States or parts of States. Though the Commonwealth had power to impose direct taxes from the date of federation it did not begin to do so until 1915, when, as a means of providing additional funds for the First World War it imposed income tax for the first time. Before 1915 it had relied on customs and excise for the greater part of its revenue. State governments had imposed and collected income tax for some time prior to 1915 and continued to do so after the Commonwealth first imposed income tax in 1915. This meant, of course, that taxpayers in each State faced two sets of tax laws and were required to complete two income tax returns so that income tax could be paid to both State and Federal governments. Some uniformity was achieved in 1936 when the *Income Tax Assessment Act* (Cth) 1936 was adopted as a model by the States. Acceptance of this Act by the States meant that income tax was imposed according to the same set of rules. Complete uniformity was not achieved until 1942 when, as a wartime measure, the Commonwealth took over the income tax field exclusively. The Commonwealth's action was immediately challenged by South Australia but the High Court upheld the validity of the four Acts which the Commonwealth had enacted to give it, in effect, exclusive rights to income tax.² Since the War the States have not reintroduced a tax on income. To do so would have meant loss of financial assistance from the Commonwealth. In 1976 the Commonwealth and the States agreed on an

alternative arrangement for sharing income tax. Stage 1 of the new scheme involved the enactment of *The States (Personal Income Tax Sharing) Act 1976* which gave the States access to a fixed percentage of net personal income tax collected by the Commonwealth. Under stage 2 of the arrangement *The Income Tax (Arrangements with the States) Act 1978* gave the Commissioner of Taxation power to collect any State tax (or pay any State income tax rebate) which a State might impose (or allow). However, to date, no State has used this facility and none had indicated that it is likely to do so.

The Commonwealth income tax is, at present, levied and collected as a result of an assessment Act and various rating Acts. The main Acts are the *Income Tax Assessment Act 1936*, the *Income Tax (Rates) Act 1976* and the *Income Tax (Companies, Corporate Unit Trusts and Superannuation Funds) Act 1981*. Further details of particular provisions of these Acts are given throughout this chapter and in Chapter Four. In this chapter an analysis will now be made of five areas, outlined in Table 2.4, to see whether, and if so to what extent, the Australian tax system provides taxpayers with scope for evading tax. The five areas are: tax collection procedures, book-keeping requirements, resources used to detect evasions, the adequacy of the penalty structure and the operation of various administrative procedures.

3.3 ADEQUACY OF TAX COLLECTION PROCEDURES

Addington's first budget in the United Kingdom in 1803 was important for two reasons apart from the fact that it sought to continue with the income tax which had only been introduced four years earlier. First, it placed the structure of the tax into five schedules which still exist today

and second, it introduced the practice of deduction of tax at source. This latter practice has almost been elevated to the status of being a basic principle of taxation:

It is a general principle of the Tax Acts in the United Kingdom that as far as possible tax is charged at the point where the income first emerges from the source; and this is so even if the person primarily in receipt of the income does not ultimately enjoy it but pays it over or accounts for it to another who is the person beneficially entitled to it.³

Failure to deduct income at source means that alternative ways must be found for collecting the tax and such alternatives are likely to increase the scope for evasion. Evasion is still possible where tax is deducted at source but it is less likely because it requires collusion between at least two parties. In fact the introduction of collection of tax at source by Addington resulted in a sharp increase in the amount of tax collected without any increase in tax rates. Deduction of tax at source might increase compliance costs but experience in the United Kingdom demonstrates that it is at least administratively possible to deduct tax at source from a wide range of different types of income. At present tax law in the United Kingdom requires deduction of tax at source from the following types of income:

- (i) interest on most British Government securities;
- (ii) foreign dividends where payment is entrusted to a paying agent in the United Kingdom;
- (iii) income from office, employment, pension and certain social security benefits (e.g. widows pension, invalid care allowance, industrial death benefit paid under the Social Security Act);
- (iv) certain annuities and royalties;
- (v) mining rent and rent from land in the U.K. where payment is made to a non-resident;
- (vi) certain copyright royalties paid to non-residents; and

(vii) dividends* and other distributions by resident companies.

[* in the form of advance corporation tax nowadays]

Although tax is not required to be deducted, at source, from rental income payable to residents or income derived from a trade, business or profession the broad coverage does limit the opportunities for successful evasion. If evasion is more likely for taxpayers deriving rental or business income, then those taxpayers could be subject to more frequent investigations. Tax collection practice in Australia for the financial year ended 30 June 1982 is shown in Table 3.1.

Adherence by the Australian income tax system to the principle of deduction of tax at source is overstated in some ways by Table 3.1. For example, the use of the term "salary or wages" suggests that things commonly regarded as salary or wages are subject to deduction of tax at source. However, this is not the case even though the definition of the expression in s.221A(1) extends the coverage to include any "payments made under a contract which is wholly or substantially for the labour of the person to whom the payments are made" [para.(a)]. In practice, interpretations of this paragraph, and therefore the phrase "salary or wages", have been restricted to those situations where it can be shown that an employer/employee relationship exists. In essence, this requires one person to engage another to perform work under his control and direction (i.e. it requires the establishment of a master/servant relationship). In circumstances in which a person is required to provide his own tools, equipment or materials this relationship breaks down and tax instalments, therefore, are not required to be made. Further, where payment for services rendered is arranged to be made through an agent rather than directly to the person rendering the services, instalments are not required. This defect emanates from the words used in paragraph

TABLE 3.1

Tax Collection Practice for Income Derived by
Australian Resident IndividualsYear Ended 30 June, 1982

<i>Type of Income</i>	<i>Deduction at Source</i>	<i>Method of Collection</i>	<i>Time of Collection</i>
Salary or Wages	Yes	PAYE	Periodical instalments throughout the year
Meal, sustenance, use of premises, cash allowances	Yes	PAYE	" "
Benefits other than above, e.g. use of car	No	Year end	With annual adjustment assessment.
Retiring allowances - lump sum annual leave & long service leave	Yes	PAYE	Instalments at standard rate (32%) when payments are made.
- other lump sums	No	Year end	With annual adjustment assessment.
Income from trade, business or profession	No	Provisional* tax	Approximately 31 March, 1982.
Share of partnership profits	No	"	"
Trust income	No**	"	"
Rent	No	"	"
Royalties	No	"	"
Dividends	No	"	"
Interest	No	"	"

* Provisional tax is based on the amount of income derived during the preceding year of income. If the level of income and/or the tax rates change an adjustment will be required. The size of the adjustment will be determined when the taxpayer's return is assessed and the balance taken into account with payment of provisional tax for the following year (viz. on or after 31 March, 1983).

** Trustees are required to pay tax on income falling under s.98, ss.99, 99a, 100a, 101A and 102.

(a) of the definition of "salary or wages" in s.221A(1). The paragraph operates only where payments under a contract which is wholly or substantially for the labour of a person, *are made to the person who performs that labour.*

Hence tax instalment deductions are not required in respect of payments made to groups of individuals working in partnership or to agents on behalf of the person performing the services. Individuals who form "one man companies", trusts or partnerships and who contract through those entities, rather than contract personally, can also avoid P.A.Y.E. instalments. On a literal interpretation of the paragraph instalments are only required "where payment is made directly to the person rendering those services". Thus where payment is made to an interposed entity or to an agent no instalments are required.

The Asprey Committee recognised some of the problems with the present requirements and recommended that instalments be required where payment was substantially for the labour of one person or a small group of persons - irrespective of whether an employer-employee relationship existed.⁴ The Committee further recommended that provisions be introduced to ensure that coverage was extended to "the building and construction industry; primary production including forest and fishing operations; the entertainment industry, including professional sport and freelance writing" and to "fringe benefits". They further argued that present instalment requirements in respect of meals, sustenance and use of premises required updating.⁵

There is evidence to suggest that deductions of instalments from wages and salaries are still not made in many instances in the building industry. Attempts to prevent evasion in this industry have not been

entirely effective. In 1978 the Government announced⁶ that it was looking at ways to curb tax evasion from cash transactions including those in the building industry. Some three years later, in reply to a question in Parliament, the Treasurer said:

We have for some time been in discussion with the building industry and have been looking at ways in which things might be introduced in respect of that industry. We have done this in a way that would not cause any disruption, but at the same time we have worked towards a reduction in the amount of tax evasion. It is something that we are trying to do in co-operation with the building industry and it also has, as I understand it, the active interest and support of a number of the building trades unions which have an interest in preventing tax evasion practices.⁷

Finally, in his Budget Speech of 17 August 1982, the Treasurer announced⁸ that the Government was going to do something to reduce evasion in this area. He stated that legislation is to be introduced - to take effect from 1 July 1983 - to catch those persons not declaring income consisting of payments for labour and services. The proposed measures are directed primarily at those in the building industry. The new system is to be made up of two parts: firstly, selected payments for labour and services, not presently subject to P.A.Y.E. provisions will have tax deducted at source at rates to be determined by regulation; and secondly, householders who enter into certain building or construction projects will be required to report certain prescribed payments made in connection with projects whose cost exceeds \$3,000.

Existing P.A.Y.E. provisions are also to be amended:

- (a) so that they apply only to payments wholly or *principally* for the payee's labour;
- (b) to restrict a householder's liability to make P.A.Y.E. deductions to payments made to a person who is an employee in the ordinary sense of that word; and
- (c) to make it clear that payments wholly or principally for the labour of the payee fall within the existing system -

- (i) where the payee performs or is to perform the labour even though he or she has the right under contract to engage other persons to do it; and
- (ii) where the payee is an individual who renders services, or performs, as a musician, entertainer or other person of creative talent.

The Treasurer has also warned that "to ensure compliance with the system and to guard against its abuse, the legislation will provide appropriate and substantial penalties for breaches of it."⁹ The effectiveness of these provisions, if enacted, cannot yet be gauged. In fact until the relevant legislation is introduced the full effect of these proposals cannot be fully appreciated.

Until changes are made scope continues to exist for successful evasion in respect of income derived from the rendering of personal services. Scope for evasion also exists for taxpayers who derive other income. Non-wage and salary earners are required to pay the bulk of their tax by way of *provisional tax*. The system of payment of provisional tax has operated since 1944 and requires payment in a single sum nine months into the year of income. More than one million taxpayers pay provisional tax and this confers on them at least two distinct advantages over taxpayers who pay tax on a P.A.Y.E. basis. Firstly, provisional tax payments usually fall short of actual liabilities and as any shortfalls are not paid for another twelve months thus taxpayers have the use of their funds for longer periods. If P.A.Y.E. instalments are insufficient the shortfall is required to be made up soon after an assessment is received. Ironically, P.A.Y.E. instalments are usually in excess of actual liabilities and refunds are subsequently made. Secondly, although provisional tax is required to be paid in a single sum it is not paid until after the expiry of approximately nine months of the year of income. This confers a similar advantage on provisional taxpayers because P.A.Y.E.

instalments are made each week or each fortnight as income is derived. To improve equity the Asprey Committee recommended that there be two instalments of provisional tax and that any shortfall be paid separately, soon after the end of the year of income.¹⁰ Although this would improve equity it would not necessarily reduce the opportunity for evasion.

In view of experience in the United Kingdom there seems little reason not to require deductions of tax at source from interest, dividends, royalties, annuities and mining rents. There also seems to be little reason why trust income should not also be subject to tax instalment deductions where appropriate. In the United States, the *Tax Equity and Fiscal Responsibility Act* 1982 will expand withholding of tax responsibilities. The Act will generally require the withholding of tax at the rate of 10% on the payment of dividends and interest made after 30 June 1983. The purpose of this is twofold: to increase taxpayer compliance and to generate additional revenue.¹¹ Pensions, annuities and certain other deferred income payments will be subject to tax instalments from 1 January, 1983. Although extension of the principle of deduction of tax at source may mean overpayment of tax by some taxpayers it would, apart from reducing the opportunity for evasion, also improve taxpayer compliance in another respect. As Murray once noted:

The prospect of a tax refund tends to elicit the taxpayer's co-operation and encourages prompt return filing. It is normally more difficult to collect tax bills in small amounts than to distribute refunds of like magnitude.¹²

If instalments required under such an extended system were likely to greatly exceed taxpayers' final liability to tax taxpayers might be given the opportunity to request a variation in tax instalments. A similar provision (s.221D) presently exists under the Act for salary and wage earners.

3.4 ADEQUACY OF RECORD KEEPING REQUIREMENTS

Evidence before the Radcliffe Commission suggested that evasion can begin with careless record keeping. In particular small-scale traders often evaded tax because their records were inadequate to properly reflect their true income. To reduce evasion the Commission favoured some minimum statutory requirement regarding the nature of records which should be kept. They recommended that traders be required to keep a record of all receipts and payments, the value of opening and closing stock and the amount of opening and closing balances of accounts receivable and payable. If it is true that inadequate records can lead to evasion then an evaluation of the record-keeping requirements of taxing statutes can indicate whether the tax system itself facilitates evasion.

The record-keeping requirements of the *Income Tax Assessment Act* 1936, as amended, are now analysed. In *Re Prince; Ex post the Bankrupt*¹³ it was held that cards in a filing system, pay-in books, cheque butts and bank statements did not amount to "books of account" for purposes of the *Bankruptcy Act* 1924-1960. However, the *Income Tax Assessment Act* does not require the keeping of "books of account". Rather, it provides that:

s.262A(1) Subject to sub-section (2), every person carrying on a business shall keep *sufficient records* in the English language of his income and expenditure to enable his assessable income and allowable deductions to be *readily ascertained* and shall retain such records for a period of at least seven years after the completion of the transactions, acts or operations to which they relate.

[emphasis added]

Those taxpayers who might be aware of s.262A are unlikely to be able to translate phrases such as "sufficient records" and "readily ascertained" into actual book-keeping requirements. Enquiries of the Taxation Office¹⁴ and of the Tax Agents' Liaison Centre did not enable the author to determine what books ought to be kept. The Tax Office

seems to be satisfied provided a taxpayer's records are in English, legible, orderly and allow his taxable income to be readily determined. Thus, if all a taxpayer has is an orderly set of record cards, the Tax Office would be satisfied. The record keeping requirements of s.262A appear to be inadequate and fall well short of the Radcliffe Commission's recommendations. The inadequacies of the section are only too apparent: firstly, as noted above, the section is couched in terms of "records" which should be kept rather than "books of account" and this is a much less formal requirement; and secondly, the section only extends to taxpayers carrying on business and not to all taxpayers.

It appears that some taxpayers are aware of the inadequacies of s.262A. Certain practices have developed which take advantage of that section and these practices have been serious enough to receive special mention by the Commissioner of Taxation in his 59th Report:

Companies or trusts with current year profits are denuded of assets in a way which completely disregards the rights of creditors or potential creditors. This action is the more egregious when members of the company resolve to place it in voluntary liquidation before an income tax assessment can be issued so that early destruction of records may be achieved.¹⁵

The *Income Tax Regulations* extend the requirements of the Assessment Act. For instance Reg. 9(1)(b) provides that "every return under the Act shall ... be accompanied by all such balance sheets, profit and loss accounts, statements and other documents, as are mentioned ... or as are requisite." However, further reading of the Regulations indicates that this requirement does not extend to all taxpayers but rather only to companies, superannuation funds, partnerships and trusts. More importantly the Regulations do not appear to impose any greater book-keeping requirement than does the Act. All that the above regulation requires is the

results of particular accounting procedures be stated, it does not indicate how these results should be achieved, i.e. it does not prescribe any particular accounting methods, procedures or books.

The Asprey Committee made a number of recommendations with respect to the form and content of information which should be supplied with annual returns. Their recommendations included:

- (i) that the present requirements to supply balance sheets and/or statements of assets and liabilities with income tax returns should be enlarged;
- (ii) that these requirements be extended so that a balance sheet or statement of business assets and liabilities is also supplied with each income tax return of a taxpayer carrying on a business or profession; and
- (iii) that a standard form of balance sheet or statement of assets and liabilities should be issued by the Commissioner for completion and forwarding with returns other than company returns. ¹⁶

The Committee also made recommendations in respect of the agent's certification suggesting that the current practice be reviewed by the Commissioner in consultation with members of the accounting profession and organisations representing tax agents:

to develop a question or series of questions that would go further towards securing a statement from the tax agent recording the steps he has taken to ensure the accuracy of the returns covered by his certificate. ¹⁷

But these recommendations fall short of those of the Radcliffe Commission which outlined a minimum set of records which should be kept. If a basic set of records was prescribed consideration could then be given to standardising the format of those records. Such a move would facilitate preparation of annual returns by taxpayers and should speed

up processing of those returns by the Tax Office. It might also provide an alternative mechanism for taxpayers to discharge their obligations in respect of annual returns. At least some taxpayers are unlikely to be aware of exactly what is required in terms of balance sheets, profit and loss statements, statements of movements in reserves and provisions and the like. Further, those who are aware of what is required may not have the technical competence to meet those requirements. These taxpayers could be permitted to submit balanced sets of books in order to discharge their obligation. These books would then be passed on to a person competent to prepare the necessary returns.

3.5 ADEQUACY OF RESOURCES USED TO DETECT EVASION

3.5.1 Enforcement Activities of the Australian Tax Office

According to Allingham and Sandmo probability of detection and the penalty for evasion are the two main policy tools which are available to revenue authorities to combat evasion. Behavioural scientists have viewed the effects of these two variables from a different standpoint. They argue that, if probability of evasion and the penalty for evasion are inversely related with the extent of evasion, it is a result of *taxpayers' perceptions* of these two variables, i.e. taxpayers' perceptions of the probability of their evasion being detected and taxpayers' perceptions of the severity of penalties for evasion. In this part of this chapter an analysis is made of the tax system itself and not taxpayers' perceptions about it. The latter will receive attention in Chapter Five.

Much of the analysis in this part emanates from information contained in the annual reports of the Commissioner of Taxation. This might bias the findings but, unfortunately, alternative sources of information are

not available. The 57th Annual Report of the Commissioner of Taxation suggested that enforcement policy was not as strong as it ought to have been over preceding financial years to 1977/78 because of the need to deploy staff to introduce new technology and to assist in new policy initiatives in assessment and collection. "The necessity to deploy staff for these basic purposes caused some curtailment of enforcement activities and this must be regarded as having brought about at least deferment, if not loss, of some tax revenue."¹⁸ On the other hand, computerisation together with a new *file number* system should, in the long run, assist in detecting, if not also preventing, some evasion:

Information is also retained on computer files for post-assessment processing of a law enforcement nature. This enables selection for further examination of possible cases of incorrect returns and deliberate attempts to evade tax ... systems have been developed to cross check the validity of information shown in returns lodged by married couples to check information obtained from dividend and interest listings supplied by companies and building societies against taxpayers' returns and to identify cases for inclusion in the field audit program.¹⁹

One other important development is the establishment of a *Compliance Division* within the Tax Office administration framework. The purpose of this Division is "the planning and co-ordination of investigation, audit and inspection activities ... with the aim of securing the maximum practicable degree of compliance with the taxation laws ... it is responsible at the national level for planning and co-ordinating administrative activity in relation to legal tax avoidance schemes."²⁰

According to the 59th Report of the Commissioner of Taxation:

(i) a further 400 staff were recruited since September 1979 and this led to a marked increase in short term compliance.²¹

(ii) a good deal of the increased staff was directed into

the area described as "internal check" the main objectives of which were the detection of omissions of income, the detection of false rebate claims and the identification of taxpayers who should have, but who had not, lodged tax returns.²²

The results of enforcement activities over recent years are shown in Table 3.2.

TABLE 3.2

Enforcement Activities, Commonwealth of Australia,
Income Tax Years 1977-78 to 1981-82

	<u>1977-78</u>	<u>1978-79</u>	<u>1979-80</u>	<u>1980-81</u>	<u>1981-82</u>
<u>1. Investigations</u>					
No. of investigations	7747	7540	7037	6752	5395
Increase in tax assessed plus penalties	\$69.4m	\$95.3m	\$88.0m	\$76.7m	\$92.1m
<u>2. Field Audits</u>					
No. of audits conducted	-	10,333 ^a	11,507	10,198	8,775
No. of audits revealing evasion	-	7,279	8,982	8,235	6,131
Increase in tax assessed plus penalties	-	\$37.2m	\$48.9m	\$51.5m	\$50.5m
<u>3. Internal Check</u>					
No. of assessments adjusted	NA	NA	NA ^b	NA	NA
Increase in tax assessed plus penalties	NA	NA	\$27.3m	\$39.5m	\$35.6m
<u>4. Inspection re P.A.V.E. Provisions</u>					
No. of inspections	141,000	229,000 ^c	173,814	158,060	151,942
No. of prosecutions instituted	-	-	NA	5,246	6,869

(a) First year of operation.

(b) No figures are available. However \$19.8m of the increased tax and penalties resulted from adjustment of 63,000 assessments for omissions of dividends and interest. The corresponding figures for 1980-81 were \$29m and 83,599 assessments; and for 1981-82 were \$27m and 65,154.

(c) "Inspections in 1978-79 revealed evidence of an increasing tendency by employers and employees engaged in some industries to enter into contractual and other arrangements to circumvent the operation of the existing tax instalment deduction provisions of the income tax law."
[58th Report, p.12]

Source: *Annual Reports of the Commissioner of Taxation.*

Increased "tax assessed and penalties" more than doubled over the three years to 1979-80. This was partly due to a change in enforcement policy (*viz.* the implementation of field audits) and partly due to increasing yield from *investigations* (\$8,958 per investigation in 1977-78 to \$17,071 per investigation in 1981-82). As yet, only four years' figures are available for *field audits*, consequently there cannot be any inference as to the increasing effectiveness of this activity. In the first year of operation (1978-79) 70% of audits revealed evasions whereas in the second year (1979-80) the corresponding figure was 78% indicating, perhaps, an improvement in the effectiveness of audits. In 1980-81 the rate fell marginally to 75% and in 1981-82 there was a further marginal fall to 70%. The emerging pattern is not altogether clear. Further, the average increase in tax assessed per audit rose from \$3,600 in 1978-79 to \$5,754 in 1981-82. It can be expected that as audit staff become more familiar with audit techniques, these improvements should continue, though at some stage one would hope to see a decline in productivity which may be indicative of greater voluntary compliance.

According to Table 3.2 there does seem to be an alarming decrease in the number of "investigations" and "inspections" since 1978-79.

The reason is given in the 60th Report of the Commissioner of Taxation:

It is appropriate to comment that, as at the time of making this report, resources employed in enforcement activities have had to be considerably reduced owing to the recent decrease in staff ceiling. The combined effect of this reduction and the need to deploy substantial resources to the investigation of tax avoidance activities has seriously affected capacity to detect and control tax evasion and, as I have stated in previous Reports, is a matter of considerable and increasing concern to me. ²³

The number of staff employed by the Taxation Office is shown in Tables 3.3 and 3.4. Also shown is the number of staff per thousand tax returns lodged. While the actual number of staff employed has risen by 9%,

TABLE 3.3

Total Number of Staff Employed, at 30 June Each Year, by the Australian Taxation Office - 1974/75 to 1981/82

<u>Year</u>	<u>No. of Staff</u>	<u>No. of Returns Lodged</u>	<u>No. of Staff per '000 Returns</u>
1974-5	11,740	7,733,000	1.52
1975-6	11,870	7,917,000	1.50
1976-7	11,841	8,128,000	1.46
1977-8	11,802	8,254,000	1.43
1978-9	11,910	8,405,000	1.42
1979-80	12,323	8,487,000	1.45
1980-1	12,311	8,745,000	1.41
1981-2	12,773	9,018,000	1.42

Source: *Annual Reports of the Commissioner of Taxation.*

TABLE 3.4

Number of Investigation Officers Employed, at 30 June Each Year, by the Australian Taxation Office - 1974/5 to 1981/2

<u>Year</u>	<u>No. of Staff* Employed</u>	<u>No. of Staff per '000 Returns</u>
1974-5	938	0.121
1975-6	1,024	0.129
1976-7	1,028	0.126
1977-8	974	0.118
1978-9	937	0.111
1979-80	1,013	0.119
1980-1	983	0.113
1981-2	1,060	0.118

[* About two-thirds involved in Income Tax and one-third in Sales Tax.]

Source: *Annual Reports of the Commissioner of Taxation.*

between 1974-75 and 1981-82, the number of staff per thousand returns has fallen by 7%. This has been due to the 17% increase in the number of returns being lodged.

Work of the tax audit staff has undergone a change in emphasis which, we are told, has increased the recovery of tax. Little information

is available concerning this change of emphasis other than the brief comment that, now, audits are less exhaustive than before. The purpose of this change, we are told, is to increase the cost effectiveness of investigations, but no evidence is available to confirm that this purpose is being achieved. A more likely explanation of the reduced intensity of audit, apparent from Tables 3.3 and 3.4, is the critical shortage of staff.

3.5.2 The Use of Computers to Detect and Prevent Tax Evasion

According to one report about the United States Internal Revenue Service "the use of DIF formulae has significantly improved the audit selection system. It has helped reduce the percentage of individual taxpayers contacted whose audit resulted in no tax change from 43% in 1968 to 23% in 1975."²⁴ Compliance characteristics of all returns filed are determined from a random sample (n = 50,000) using the ending digits of the social security numbers. This is done every three years and those returns are thoroughly audited. Though most returns selected for audit in the United States are chosen by use of the discriminant function formulae a number are also selected at random to ensure that all taxpayers have some chance of being exposed to official investigation. There is no evidence to suggest that the Australian Taxation Office is selecting taxpayers for investigation by use of computerised discriminant function formulae as is the case in the United States. In fact there is evidence to suggest that the Australian Tax Office is not yet ready to use this approach. Over the last few years the Tax Office has only just started to computerise its tax files and this, together with staff ceilings now imposed would make it difficult for it to embark upon new projects.²⁵

Also, according to the 61st Report of the Commissioner of Taxation, problems have been encountered in the past few years because computer based systems

have not been integrated. Rather than having one overall system, there appear to have been many separate systems.²⁶

3.5.3 Use of Regional Offices

Another trend which could assist in tax audit and tax investigation work is the use of regional offices. At present, though, only a handful of offices exist in regional areas whereas in the United Kingdom there are over 700 district offices. The use of regional or district offices should provide a more convenient base for tax audits and tax investigations. But rather than increase the number of regional offices and upgrade their ability to detect evasion, the reverse appears to be the case in Australia:

The Taxation Office advised that the functions of regional offices had been reviewed and it had been decided to withdraw investigation officers to maximise use of resources. However, this would not affect service to public in areas of lodgement of returns, lodgement programme, etc.²⁷

3.5.4 Adequacy of Commissioner's Powers to Obtain Information

Though s.263 does not empower the Commissioner to seize a taxpayer's books, papers or other documents he has, on occasions, used s.10 of the *Commonwealth Crimes Act* to do so.²⁸ This section, in effect, provides that, in certain circumstances,²⁹ a Justice of the Peace may authorise a constable of police to enter the place described in the warrant and seize any such things for which there are reasonable grounds for believing that they will afford evidence as to the commission of any offence against the laws of the Commonwealth. In respect of income tax laws, such offences would include failure to submit a tax return or submission of a tax return which was false in any material particular. According to Burges and King³⁰ s.10 of the *Commonwealth Crimes Act* may have application "if, for example, the Commissioner was concerned that, if a document was discovered on a

search under s.263, it may disappear before a s.264 notice was able to be issued."³¹ Given these additional powers it still seems that they fall short of those contained in the United Kingdom Act because it is doubtful whether the Commissioner can use force to gain access to premises or to inspect documents.³² Similar provisions appear in the Canadian Act. Section 231(4) of the Canadian Act gives authority to tax officers to obtain a search warrant, on the approval of a judge of a Superior Court, to search premises and seize records. However, where an investigator is satisfied that he can obtain the required evidence without resorting to a search he can, on special authorisation signed by a Deputy Minister, seize and remove available records and documents from a taxpayer's premises [s.231(1)(d)]. Section 231 also gives authority to require answers either orally or in writing, on oath or by statutory declaration. Failure to comply with the section can bring fines from \$200 to \$10,000, or both a fine and imprisonment.

The Commissioner's powers, in Australia, under s.263 are much more limited than those of his counterparts in either the United Kingdom or Canada. Further powers to obtain information are given in s.264 which in essence, provides that the Commissioner may by notice in writing require a person to furnish him with such information as he may require, to attend and give evidence and to produce all books, documents and other papers in his custody. This provision lacks a good deal of force. Since the decision in *Ganke's Case*³³ it seems that:

- (i) The information must be described with sufficient detail so that the recipient can reasonably determine what information he is required to furnish;
- (ii) The notice should specify the time and place at which the information is required to be furnished;

- (iii) A person cannot be required to furnish information which is not available to him after consulting documents in his possession.³⁴

The scope of the Commissioner's powers under s.264 to require persons to attend and give evidence and to produce documents, papers and books was considered in *Smorgon's Case*.³⁵ The case arose out of a challenge to the validity of notices which required a bank to produce documents contained in a safe deposit box held in a branch of the bank. Also challenged was the validity of notices served on members of the Smorgon family requiring them to attend and give evidence and to produce the same documents. In determining the validity of the notices, the Court decided that:

- (i) The Commissioner can validly issue a s.264 notice requiring a bank to produce documents contained in a safe deposit box kept on its premises since the bank has the necessary custody or control of those documents required by the section;
- (ii) The only documents that the Commissioner can require to be produced are those that relate to the income tax of some person and that person must be named or otherwise indicated in the s.264 notice;
- (iii) The power in s.264 can be exercised whether or not an issue or dispute has arisen between the taxpayer and the Commissioner. Therefore the section enables the Commissioner to fish for information to determine the amount of taxable income of any person.

While the Commissioner was successful in *Smorgon's Case* in exercising his powers to gain access to information it seems doubtful whether the Commissioner can use force to gain access to premises or to inspect documents.³⁶ Elsewhere in *Smorgon's Case*, Stephen J. agreed

with the taxpayer that a notice which required a person to produce all other books, papers, writings, and documents, concerning specified matters, which were in his custody was unreasonable and oppressive. Thus, where a notice lacks that degree of particularity which would enable a person to know whether he had properly complied with it, then it is likely to be regarded as invalid.

Section 264(1)(b) is also defective in other ways. First, it only empowers the Commissioner to require natural persons to attend and give evidence. Thus notices served on companies would be ineffective. The Commissioner, in these circumstances, must direct questions to officers of the companies. Second, it does not specify the time in which taxpayers are to provide the required information. Consequently the Courts have decided that the time must be reasonable. What is reasonable depends upon the nature and amount of information required.

Only a few new powers have been given to the Commissioner of Taxation which will assist him in his task of combating evasion, unlike the United Kingdom, where the Revenue's powers were increased substantially in 1976. Sections 20A-D of the equivalent Act were added, effective from 31 July 1976, to give the Revenue power to:

- (i) enter and search premises where there is reasonable ground for suspecting an offence involving tax fraud (s.20C);
- (ii) call for books, accounts and other documents either from the taxpayer or from certain other persons (s.20A); and
- (iii) require any tax accountant, who is convicted of certain tax offences after 30 July 1976, to produce documents which relate to any of his clients' affairs.

These powers have been used sparingly and only for the more serious offences. For instance, in the first three years to the end of 1979, s.20C had only been used to apply for warrants on twelve occasions. This resulted in the search of 65 different premises. Subsequently, five of the twelve cases had come before the Courts and prison sentences have been imposed on fourteen individuals. No similar powers exist in Australia. Those powers which do exist appear to be inadequate and appear to be overdue for reform. Any reform proposals should, at least, consider the 1976 changes to the *Tax Management Act* 1970 (U.K.).

However, over recent years in Australia few new powers have been given to the Commissioner of Taxation to help him prevent evasion. One new piece of legislation which has been enacted is *The Crimes (Tax Offences) Act* 1980 which received Royal Assent on 4 December 1980 and it exposes to penalty:

- (i) a person who enters into arrangements or transactions which secure a company's or a trust's inability to pay income tax;
- (ii) a person who enters into such arrangements or is in any way concerned in, or party to, the entry by another person in the knowledge or belief that the arrangement will secure a company's or a trust's inability to pay income tax; and
- (iii) a person who aids, abets, counsels or procures another person to be party to such arrangements or transactions.

Unlike previous legislation this legislation is aimed at penalising specialist tax advisers as well as the principals to the transactions or arrangements. A person convicted of an offence under the Act may be sentenced to up to five years imprisonment or to a fine of up to \$50,000 or both. The person may also be ordered to pay some or all of the tax

evaded. The speed with which this Act was introduced and passed and the severity of the penalties indicate the seriousness of these evasion practices. Further, according to one report one promoter is alleged to have stripped 2,086 companies with the result, in 733 of these cases, that the Commissioner will be unable to collect income tax of about \$60 million.³⁷ Whether this new legislation will have a significant impact on the extent of tax evasion remains to be seen. Hill³⁸ does not believe that the legislation adds significantly to the Commissioner's powers, but he does warn that, in practice, this new Act might be used to discourage would-be evaders:

In practice, however, interested persons will be not particularly concerned ultimately with the question whether or not a conviction under the legislation could be secured but with the more pragmatic question of whether a prosecution would be likely to be brought. No doubt it could be ruinous for a prosecution to be brought which was unsuccessful if the defence involved a lengthy hearing at which senior counsel would be briefed.³⁹

3.5.5 Appointment of a Special Prosecutor to Help Prevent Tax Evasion

One further development (22 September 1982) which will assist in the recovery of evaded tax is the appointment⁴⁰ of a Special Prosecutor (Mr. Roger Vincent Giles, QC) who will be authorised to carry out prosecutions for offences against laws of the Commonwealth in matters referred to him by the Attorney-General. The Attorney-General has announced⁴¹ that this Special Prosecutor is to be assisted by a "Task Force" consisting of lawyers, taxation officers and police to deal with prosecution of persons directly involved in the promotion and execution of "bottom of the harbour tax evasion schemes."⁴² These schemes may, according to Mr. Costigan, have cost the Revenue Authorities hundreds, if not thousands, of millions of dollars.⁴³ Even the Commissioner of Taxation concedes

that at least A\$465m (approx. stg£270m) have been evaded by these schemes.⁴⁴ In his 61st Report the Commissioner gave details of the number of companies he regarded as being involved.⁴⁵ Some 4,565 companies had been identified at 8 October 1982 and a further 538 companies were under examination. The Commissioner believed that the identification process was continuing and numbers were expected to increase.

The proliferation of "bottom of the harbour schemes exposed a further weakness in the Revenue Authorities' resources in preventing tax evasion, viz. gross negligence in the Crown Solicitor's Office. According to the *Financial Review* (25.8.81), the Fourth Interim Report of the Costigan Royal Commission into the Federated Ship Painters and Dockers' Union "recorded a shocking state of affairs which can be summarised thus:

- . A Crown law officer disobeyed an instruction from the Deputy Crown Solicitor in 1977 - two years after the prosecution could have been launched - that he marshall the documentary evidence so it could be presented to the Crown Solicitor.
- . The same Crown law officer failed to put the documents instructing counsel to proceed with the prosecution on to the departmental file but kept them in his bottom drawer where they were discovered, five years later, in 1982.
- . A legal officer of the Crown Solicitor's Office, a Mr. Bercove, conducted a prostitution service using the Perth phone number of the Crown Solicitor's Office in advertisements for the business.
- . The wife of the same legal officer acted as secretary for as many as 100 stripped companies as part of a bottom-of-the-harbour tax avoidance scheme and was asked to do so by an unnamed man who was a close associate of the also unnamed promoter and 'a close associate of painters and dockers and has acted as a recruiter of them for the purposes of the taxation fraud.'

- . While his wife was engaged in these activities, using their home address for the stripped companies, the legal officer was engaged in collection of taxation debts for the Crown Solicitor.

The Crown law officer and the legal officer have been suspended from duty pending charges under the Public Service Act. The crux of the above is that the Crown Solicitor's failure to prosecute resulted in the proliferation of these "bottom of the harbour" schemes. In an effort to mitigate the loss of revenue from these schemes the Government announced (25 July 1982) its intention to introduce *retrospective legislation* to recover evaded tax from the vendor shareholders.⁴⁶ Recovery will be by way of special tax payable by persons who beneficially received the proceeds of the sale of shares. The tax will generally be due for payment thirty (30) days after the assessment is issued and a special penalty of twenty per cent per annum will be payable on any tax remaining unpaid after that period. At the time of writing (1 December, 1982) the retrospective legislation had not received Royal Assent.

3.6 ADEQUACY OF PENALTIES FOR EVASION

Under the Australian income tax system penalties can be imposed as a result of the operation of the *Income Tax Assessment Act*, the *Income Tax Regulations*, and since 4 December 1980 under *The Crimes (Tax Offences) Act*. Though the severity of the penalties varies with the nature of the offence the penalty which is actually imposed is often the subject of determination by the Commissioner. The Commissioner does not have a free hand when determining the amount of the penalty to be imposed. Relevant provisions of the legislation usually set down the structure of penalties within upper and lower limits. This gives the

Commissioner some discretion in setting the amount of penalties. The penalties imposed will reflect his views on the seriousness of the offences. Taxpayers who are dissatisfied with having penalties imposed on them may appeal to the Courts, which then decide whether the penalty should have been imposed and whether the amount of the penalty is justified. Courts have the power to reduce penalties imposed though not below the statutory minimum.⁴⁷ The main penalties imposed under the *Income Tax Assessment Act* are shown in Table 3.5. (N.B. Some of these penalties can be imposed for avoidance as well as for evasion.)

Though the list in Table 3.5 is not exhaustive it contains the main features of the penalty structure within the Assessment Act, its Regulations and *The Crimes (Tax Offences) Act* 1980. The list has been generated from the relevant provisions of the Act and does not reflect Departmental practice in respect of voluntary disclosures of income not previously declared. There is, in practice, a difference between the penalties which are levied in cases of voluntary disclosure and those which are levied in cases of non-voluntary disclosure. Table 3.6 gives a summary of the penalties applied where disclosure is voluntary.

The Commissioner of Taxation has a power [s.226(3)] to remit additional tax, or any part thereof, which has previously been imposed. Though he has this power he is not compelled to use it.⁴⁸ According to an announcement by the Treasurer on 10 August 1982 "the Commissioner's power to remit all or part of the penalty for late payment will be limited to circumstances where late payment is due to business or other factors beyond the taxpayer's control, provided the taxpayer has taken reasonable steps to mitigate the effects of those factors."⁴⁹ Boards of Review can consider the amount of tax imposed and have on occasions

TABLE 3.5

(a) Penalties Imposed Under the Income Tax Assessment Act,
1936 as amended, as at 30 June, 1982

<u>Section</u>	<u>Offence</u>	<u>Penalty</u>
s.16(6)	Disclosure, by a Taxation Officer, of confidential information.	\$500 or 12 months imprisonment.
s.82T(2)	Wilful false declaration of the value of shares.	\$1,000
s.128(c)	Failure to pay withholding tax within the prescribed time.	10% p.a. of the* amount unpaid.
s.136A(7)	Failure to make arrangements for payment of tax on film royalties paid to non-residents.	\$200 max plus tax payable by non-resident on such royalties.
s.207(1)	Failure to pay tax on due date.	Interest at 10% p.a.*
s.213(2)	Failure to give security for tax on income derived from a business regarded by the Commissioner as being established or carried on for a limited period.	\$4 - \$200
s.215(4)	Failure of liquidator of a company to comply with s.215.	\$2 - \$100 plus tax payable by company being liquidated.
s.218(2)	Failure by debtor of a taxpayer to pay amounts due to the Commissioner, as requested by the Commissioner.	\$100
s.221(1)	Failure of liquidator of a company to pay company tax.	\$200 or 6 mths imprisonment or both plus an amount not more than twice the amount due by the company.
s.221C(1A)	Failure by employer to deduct instalments due from wages and salaries.	\$40
s.221D(2)	Failure to vary tax instalments of employees as requested by the Commissioner.	\$40
s.221E(3)	Failure by an employee to return an exemption from instalment certificate.	\$40

* To be increased from 10% to 20% in 1983 when amending legislation is passed.

Table 3.5 (contd.)

<u>Section</u>	<u>Offence</u>	<u>Penalty</u>
s.221E(4)	Alteration of above certificate.	\$100
s.221F(12)	Failure by group employers in respect of group instalments (various offences).	Various. Some max. \$1000 or max. 6 mths. imprisonment Others max. \$200.
s.221G(6)	Failure of non-group employers in respect of tax instalment deductions and tax stamps.	As above for s.221F(12)
s.221M(1)	Failure to deliver tax stamps on request by Commissioner.	\$100
s.221T	Unauthorised sale of tax stamps.	\$200
s.221V	Various other offences by employees in respect of tax instalments.	\$4 - \$1,000 or 6 mths. imprisonment.
s.221Y	Forgery of tax stamps or dyes	Up to 5 years imprisonment.
s.221YDB(1)	Inaccurate (i.e. > 10%) estimate of provisional income.	10% of under estimated tax liability.
s.221YL(4A)	Failure to deduct withholding tax.	Max. \$200
s.221YN(2)	Failure to remit withholding tax by the required time.	Max. \$1,000 or 6 mths imprisonment.
s.221YP(4)	Failure to remit withholding tax where dividends not in money.	Not more than \$200.
s.221ZB(2)	Failure to deduct mining withholding tax.	Not more than \$200.
s.223	Failure to furnish returns or information.	\$4 - \$200
s.224	Refusal to give evidence required by the Commissioner.	\$4 - \$200
s.225(1)	Failure to comply with a Court Order.	\$20 - \$1,000
s.226(2)	Omission of assessable income or claiming allowable deductions not actually incurred.	Double the tax avoided or \$2 - whichever is the greater.
s.227(1)	False returns or statements.	\$4 - \$200

Table 3.5 (contd.)

<u>Section</u>	<u>Offence</u>	<u>Penalty</u>
s.228(1)	Failure to sign an agent's certificate or giving false certificate.	\$2 - \$100
s.229	Declarations made knowingly and wilfully to be false.	Liable for imprisonment 4 years.
s.230	Understating income.	\$40 - \$1,000 plus max. of double the tax avoided.
s.231	Fraudulent avoidance of tax.	As above.
s.232	Obstructing tax officers in the discharge of their duties.	\$2 - \$100
s.251J(10)	Failure of tax agent to notify change in constitution of partnership or company.	\$20
s.251K(7) and(8)	Failure of tax agent to notify of own bankruptcy or of cessation of business.	\$20
s.251L(1)	Unregistered tax agents receiving payment for preparation of returns.	\$4 - \$200
s.251N	Preparation of returns by persons not registered as tax agents.	\$4 - \$100
s.251O	Advertising by persons not registered as tax agents.	\$4 - \$100
s.252(1)(d)	Failure of a company to appoint a public officer.	\$4 a day
s.262A(1)	Failure of taxpayer to keep "sufficient" records.	\$4 - \$200

(b) Penalties Imposed under the Income Tax Regulations
as at 30 June, 1982

<u>Regulation</u>	<u>Offence</u>	<u>Penalty</u>
58LA	Failure of tax agent to return certificates of registration and exemption.	\$4 - \$40
65	Contravention of the Regulations for which there is no specific penalty.	\$2 - \$40

Table 3.5 (contd.)

(c) Penalties Imposed under *The Crimes (Taxation Offences) Act 1980* as at 30 June, 1982

<u>Section</u>	<u>Offence</u>	<u>Penalty</u>
9	Offences against the Act.	Fine (max.) \$50,000 or imprisonment (max.) 5 years or both.

TABLE 3.6

Comparison of Penalties Usually Imposed for
Voluntary and Non-Voluntary Disclosures of
Omitted Income

	<u>Voluntary</u>	<u>Non-Voluntary</u>
1. Lodgement of returns where tax becomes payable	5% - 25% of final debit on the assessment	10% - 50% of final debit on the assessment
2. Omitted Income	5% - 25% of tax evaded	Up to 200%, but usually reduced to 50% of tax evaded

Source: *Australian Federal Tax Reporter* Report No.448, 1982, at p.3. (CCH Australia Ltd).

reduced the penalty where the understatement of income was not wilful.⁵⁰

The High Court has also seen fit to reduce some penalties imposed. In *Kurauskas v Kelton*⁵¹ the Court decided that the maximum penalty should ordinarily be reserved for serious offences. The offence in this case was not regarded as serious and so the Court ordered that the penalty be reduced from \$2,500 to \$250.

When the penalties imposed under the Assessment Act are considered closely a number of anomalies become apparent:

- (i) The maximum penalty for failure to keep sufficient records [s.262A(1)] is \$200 - irrespective of the level of taxable income.
- (ii) If a taxpayer fails to lodge a return the maximum penalty is \$200 (s.223) whereas the maximum penalty for omitting income is double the tax payable on omitted income [s.226(2)]. Where taxable income is high, taxpayers aware of these provisions, might deliberately court prosecution under s.223 so as to avoid prosecution under s.226(2) in respect of the same matter.⁵²

The burden of proof imposed on a taxpayer who has been penalised under s.223 for failing to lodge a return shows up another inequity. In *Alva Natona Pty Ltd*⁵³ a corporate trustee was convicted and fined for failure to lodge a tax return even though the Commissioner did not call any evidence to prove his case. The taxpayer company argued:

- (a) that the Commissioner had not produced *prima facie* evidence that the time allowed for the lodgement of the return was reasonable;
- (b) that the Commissioner had not produced *prima facie* evidence that the company had failed to furnish a return; and

- (c) that the notice served by the Commissioner on the taxpayer requiring it to lodge the return was meaningless and void.

However, in the absence of evidence to the contrary, the Court accepted the Commissioner's allegations that the return had not been lodged.

In a later case, *Ganke v FCT*,⁵⁴ another defect in s.223 was exposed. In that case the Commissioner of Taxation was unsuccessful in his attempt to have the taxpayer lodge several prior years' returns within fourteen days of service of notice requiring the returns to be lodged. The Court decided that the time allowed to comply with the Commissioner's direction must be reasonable and that fourteen days was not reasonable. Though the taxpayer was eventually required to lodge the returns the above litigation serves merely to frustrate and complicate the administrative processes. All this would probably not happen if provisions similar to those to be introduced in the United States from 1 January 1983, were enacted: *viz.* for certain failures to file returns or information the penalty is US\$10 to US\$25 *per day* with a maximum *annual* penalty of US\$15,000.

(iii) The maximum penalty for failure to *deduct* withholding tax is \$200 [s.221YL(4A)] whereas the maximum penalty for failure to remit such tax which has been deducted is \$1,000 or 6 months imprisonment [s.221YN(2)]. Taxpayers therefore face a heavier penalty for deducting withholding tax and failing to remit it than they do for not deducting it in the first place. Perhaps this is because employers have had cash flow benefits from collections in the first case but not in the second case.

(iv) Penalties are expressed in fixed dollar terms and these are likely to lose their significance over time unless they are adjusted to take account of inflation.

Many of the penalties which are expressed in fixed dollar amounts are at the same monetary levels as they were when the Act was introduced in its present form in 1936. Since that date there would have been considerable inflation thus severely reducing the *real* burden of the penalties. Since 1941/42 when figures for average weekly earnings were first introduced those earnings have increased by almost thirty times,⁵⁶ yet most of the fixed dollar penalties have remained unchanged. This suggests, in crude terms, that the penalties are only about one-thirtieth of the severity, in 1981/82, compared with their severity in 1941/42. Such penalties are also unlikely to differentiate adequately between less serious and very serious offences. A better approach would seem to be to express penalties as a percentage of, say, the delinquent tax. Such penalties differentiate between different offences and maintain their real impact over time.

Consideration ought to be given to the penalty provisions in the equivalent Canadian Act before any reforms are made. Not only does that Act express the penalties as a percentage of the tax evaded it also distinguishes between different types of evasion. For instance, s.163(1) imposes a penalty of 50% of the tax which taxpayers sought to evade where the evasion was *wilful* whereas the succeeding sub-section imposes a penalty of only 25% where the evasion occurred through negligence on the part of the taxpayer. The enactment of such provisions allows the seriousness of the offence to be reviewed and gives assurance that there will be consistency of treatment.

Alternatively, consideration could be given to the *Tax Equity and Fiscal Responsibility Act* (USA) 1982 which imposes heavier penalties on "*substantial* understatements of income tax" for any taxable year. A *substantial* understatement of tax is then defined *viz.* an understatement

which exceeds the greater of 10% of current tax or US\$5,000 (or US\$10,000 for corporations or personal holding companies). Where penalties are imposed according to predetermined rules such as these there is more scope for consistent application of the penalty provisions. Taxpayers can then have a better perception of the likely consequences of non-compliance.

(v) The existence of prison sentences for some offences is open to criticism. Though there has been little research on the effect of penalties on recidivism of offences the research which has been done in respect of crimes against property shows that imprisonment is likely only to delay recurrence of those offences and may even lead to other more serious crimes on release.⁵⁶

(vi) The wording of s.226(2), the main operative section imposing penalties, seems to be defective. Section 226(2) imposes a penalty where a taxpayer, *inter alia*, "includes in his return as a deduction expenditure incurred by him in excess of the amount actually incurred". If these words are given their literal meaning a taxpayer could not be exposed to a penalty under this section for merely claiming a deduction for expenditure actually incurred - irrespective of whether the expenditure properly gave rise to an allowable deduction. The taxpayer would be liable for a penalty only if he claimed a deduction *in excess of* expenditure actually incurred. In 12 TBRD Case M62 the Board was not prepared to give the above words their literal meaning. They preferred to read the section as a whole to ensure that s.226(2) applied whenever deductions were overstated or income was understated. This decision has been criticised by Smith, J. in *Cyprus Mines Corporation's Case*⁵⁷ who, although not required to make a decision on this point, said that he was unable to follow the Board's reasoning in applying the relevant words

of s.226(2).⁵⁸ However, on 19 October 1982, the Victorian Supreme Court, in *Rabinov and Anor v FCT*⁵⁹ confirmed that s.226(2) does not apply where a taxpayer incorrectly claimed a deduction for expenditure actually incurred by him.

(vii) The decision in *Scanlon (DFCT) v Swan*⁶⁰ in the Brisbane District Court (July 1982) also suggests that s.232 might not be as effective as the Commissioner might have expected. In that case it was decided that a taxpayer was *not guilty* of obstructing a tax officer in the course of his duties by reason of his (the taxpayer's) refusing tax officer's access to certain documents until he had first obtained legal advice. The judge (Helman, DC.J) felt that *temporary denial* of access on reasonable grounds fell short of being an obstruction. It should be noted, however, that the decision in this case is currently on appeal.

(viii) The decision in *Aoun v DFCT*⁶¹ reveals a weakness with s.227. In that case the taxpayer, of Lebanese origin and unable to speak or read English, had a firm of tax agents prepare his annual return. The firm in preparing his return declared that the taxpayer's wife had no separate net income whereas, in fact, it was in excess of \$7,000. The taxpayer was subsequently convicted by a Court of Petty Sessions under s.227(1) for making a false return and was fined \$40. However, the Supreme Court of New South Wales set aside the conviction upholding the taxpayer's argument that he was entitled to rely on the statutory defence under s.227(2) that the false return was made through ignorance or inadvertence.

Before recommendations are made to change the structure of penalties empirical work should be carried out on taxpayers' perceptions of penalties and the effect of these perceptions on their decisions to evade, because it is taxpayers' perceptions of penalties which are taken

into account in the decision process rather than the penalties themselves. Compliance is a behavioural problem and some attempt should be made, before reforms are made, to take taxpayers' psychology into account as well as the statutory requirements. It is probable that different taxpayers might react differently to different sanctions. It is also probable that different offences might be better dealt with using different types of penalties. Further, in addition to considering penalties as a means of preventing evasion one should also consider rewards. In the United Kingdom the Commissioners of Inland Revenue are authorised, subject to the consent of the Treasury where the amount exceeds £50, to pay a reward to a person who informs them of any offence against any Act relating to the Inland Revenue. According to one report however, payment of such rewards seems to be little used. It seems that officials will admit to paying only £1,445 over a six year period to July 1980.⁶² In Australia the Revenue authorities seem to rely only on penalties. The extent of their reliance on penalties for the 1979-80 financial year is shown in Table 3.7.

TABLE 3.7

Penalties Imposed in Australia for Various Tax Offences
1979-80

<i>Relevant Section of the Act</i>	<i>No. of Taxpayers Charged</i>	<i>Additional Tax Charged \$M</i>
s.226(1)	125,637	\$ 17.23
s.226(2)	42,718	344.63
s.223	34,117	2.08
ss.227, 230, 231	442	0.20
Other	13,493	1.96
	<u>216,407</u>	<u>\$366.10</u>

Source: 60th Report of the Commissioner of Taxation.

Using the number of returns lodged as an indication of the number of taxpayers the proportion of taxpayers charged additional tax is quite low. For the 1979-80 year the proportion is approximately one in forty. Another consideration in reforming the penalty structure is that of increasing taxpayers' awareness of the penalties. Existing penalties might be more effective if information about them was better communicated to taxpayers. Research could show which media might best be used for this purpose. Research might also show whether it would be better to provide information about the actual penalties or the probability of detection. To date only a few such studies have been undertaken. One study found that, in Israel, larger fines were more effective deterrents than more frequent investigations.⁶³

The Asprey Committee⁶⁴ recommended that there ought to be a general review of the penalty structure. Among its recommendations were:

- (i) The need to provide a counterpart to s.207.

Section 207 imposes penalty interest for failure to pay tax on the due date. The Asprey Committee argued that where a taxpayer has overpaid tax and is due for a refund, then he should receive that refund *with* interest; and

- (ii) The need to allow for extensions of time to pay pecuniary penalties. At present no such facility exists irrespective of taxpayers' possible reasons for requesting extensions. The Asprey Committee believe, in the interests of equity, Courts should be given the power to grant such extensions.⁶⁵

3.7 OTHER ADMINISTRATIVE PROVISIONS

The only direct contact of most taxpayers with the tax system comes when they lodge their annual return and receive their annual

assessments. The influence this process has on taxpayers is likely to be important in determining their likelihood for evading tax. According to one newspaper report the relationship between taxpayers and the Tax Office has, over recent years, steadily deteriorated. This might have lead to increased evasion over these years. The report quoted one prominent Queen's Counsel as saying:

There was much more reasonableness on both sides 15 to 20 years ago - there was not as much hostility ... Many of the Commissioner's procedures and practices were calculated to infuriate taxpayers ... he could rarely get a reply to correspondence unless it was suited to a standard computerised form or letter dictatorial in approach and usually not fully responsive.

On many occasions they seem more concerned to wage a war than to administer the law ... this made taxpayers bitter and determined to be even more aggressive in their avoidance of tax. ⁶⁶

Letters from accountants to their Society's magazine also give instances of problems with the administrative process including delays in correcting (Tax Office) errors, delays in acknowledging and dealing with general correspondence and disallowing claims for deductions of amounts which ought to be allowable. In one case the Tax Office even disallowed a claim for accountancy fees. This made the accountant and his client quite indignant. ⁶⁷

A summary of the main features of the annual assessment procedures which exist under the Australian tax system is given in Table 3.8. This table shows strict time limits imposed whenever a taxpayer is required to act but no corresponding time limits imposed on the Commissioner. Further, when a taxpayer lodges his objection he is limited, in the event of further appeal, to the grounds stated in his objection (s.190) whereas no similar limit is imposed on the Commissioner. The decision in *FCT v Reynolds* ⁶⁸ was one instance in which the Commissioner was, in fact, entitled to change his stated ground for treating a

TABLE 3.8

Annual Assessment and Review Procedures under the
Income Tax Assessment Act, 1936 as amended

<i>Action</i>	<i>Person Required to Act</i>	<i>Time Limit (if any)</i>
Lodgement of Annual Return	Taxpayer	Two months after close of year of income
Assessment of Return	Commissioner	No time limit
Lodgement of Objection against Commissioner	Taxpayer	60 days from date of service of notice of assessment
Consideration of Objection	Commissioner	No time limit
Appeal against Decision re Objection	Taxpayer	60 days from date of service of notice of decision re Objection

particular amount as assessable. An adjustment sheet which accompanied the taxpayer's notice of assessment indicated that the Commissioner wished to rely on s.26AAA. However when the case came before the Supreme Court of Tasmania the Court allowed the Commissioner to rely on s.25(1) to support his assessment.

The taxpayer's task in preparing his initial objection is not made any easier by the fact that, in making his assessment, the Commissioner is not required to give any reasons for his actions. All the Act requires of the Commissioner is "to make an assessment of the amount of taxable income of the taxpayer and the tax payable thereon" (s.166), and then "to serve notice thereof in writing by post or otherwise upon the person liable to pay the tax" (s.174). Similarly when a taxpayer lodges an objection, although he is entitled to a decision - at some stage - he is not entitled to know the reasons for the Commissioner's decision. Section 186 of the Act governs this aspect of the procedure and states that "the Commissioner shall consider the objection, and may either disallow it, or allow it either wholly or in part, and shall service the

taxpayer by post or otherwise with written notice of his decision". The taxpayer does not have any right to know the reasons the Commissioner may have adjusted his return until shortly (not less than 14 days) before the matter is heard by a Board of Review. It is then too late for the taxpayer to alter the grounds upon which he relies. Once the assessment is issued the tax assessed must be paid (s.207). This is so even though the taxpayer may be disputing the assessment. This was confirmed in *FCT v Bevz*⁶⁹ and, according to the Treasurer's statement of 10 August 1982, the Commissioner's practice of allowing 50% of tax in dispute, in genuine disputes, to remain in abeyance until the dispute is resolved, is to be overruled by statutory enactment.⁷⁰

If a taxpayer is dissatisfied with the Commissioner's decision on his objection he may ask that the matter be referred to a Board of Review, and provided this request is made within the appropriate time, the Commissioner must so refer the matter. However, over past years this is not a speedy process. For example, as at 30 June 1981 there were 25,594 cases awaiting transmission to Boards, and during the 1980-81 financial year only 17,484 cases were resolved.⁷¹ This means that taxpayers have to wait, on average, a year and a half before the matter will be resolved. When statistics relating to the number of objections lodged and number of requests for reference to Boards of Review are analysed one trend is clear: it is evident that more taxpayers are becoming dissatisfied with their income tax assessments. Statistics for recent years are given in Table 3.9. Part of the increase in the number of objections lodged and the number of cases awaiting transmission to Boards of Review can be explained by the increase in the number of returns lodged. However, when the above figures are expressed as percentages of the number of returns lodged (see Table 3.10), the trend becomes even more apparent.

TABLE 3.9

Number of Objections Lodged against Assessments and
Number of Cases Awaiting Transmission to Boards of
Review - 1974/5 to 1981/2

<i>Year</i>	<i>No. of Objections Lodged</i>	<i>No. of Cases Awaiting Transmission</i>
1974-5	70,065	5,160
1975-6	73,997	7,356
1976-7	91,264	9,551
1977-8	132,681	10,981
1978-9	183,101	17,099
1979-80	188,768	24,217
1980-1	206,164	25,594
1981-2	189,311	25,569

Source: *Annual Reports of the Commissioner of Taxation*

TABLE 3.10

Number of Objections Lodged per Thousand Returns and
Number of Cases Awaiting Transmission to Boards of
Review per Thousand Returns

<i>Year</i>	<i>Objections Lodged - per '000 Returns</i>	<i>Cases Awaiting Trans- mission - per '000 Returns</i>
1974-5	9.06	0.67
1975-6	9.35	0.93
1976-7	11.23	1.18
1977-8	16.07	1.33
1978-9	21.78	2.03
1979-80	22.24	2.85
1980-1	23.58	2.93
1981-2	21.65	2.92

Source: *Annual Reports of the Commissioner of Taxation*

A clue to the source of this increased dissatisfaction is given
in the 59th Annual Report of the Commissioner of Taxation:

... the greatest impact of dispute by objection has arisen in relation to assessments of salary and wage earners, while requests for reference to Taxation Boards of Review and Appeals to Courts have increased for all categories of taxpayers. It is clear however, that claims for deductions in respect of expenditure related to employment has constituted the greatest single cause of the growth in disputed differences between taxpayers and the administration. ⁷²

Though this indicates the source of the problem it does not explain why this group of taxpayers have taken this action.

Non-taxable assessments, on the other hand, would permit some disputes between taxpayers and the Tax Office to be settled at least twelve months earlier than is presently possible. Under the law as it stands if a taxpayer lodges a return upon which no tax is payable the Commissioner is not required to issue an assessment. If there is no assessment the taxpayer cannot lodge an objection. Thus, a taxpayer who carries on business during the year and incurs a loss, is required to lodge a return even though he is not entitled to an assessment. He cannot have the amount of that loss confirmed until he submits his return for a subsequent year when he claims a deduction for it. If the Commissioner reduces the taxpayer's claim for the loss the taxpayer can object, but the existence of *non-taxable assessments* would have permitted this to have been done twelve months earlier.

The existence of a procedure which allows for prosecution by averment is also unlikely to meet with wholesale approval by taxpayers. This procedure allows the Commissioner to press his case without producing evidence to support the alleged facts. The Act provides for such a process in s.243(1) which states:

In any taxation prosecution, every averment of the prosecutor or plaintiff contained in the information, complaint, declaration or claims shall be *prima facie* evidence of the matter averred.

This section does not lessen the burden of proof falling on the taxpayer [s.243(5)]. Fortunately, the section does not apply where an offence is punishable by imprisonment. Nevertheless, the fact that such a section can be applied is cause for concern for some taxpayers. Just as the existence of this provision is likely to cause resistance by some

taxpayers, the absence of other provisions is likely to cause resistance by others. The absence of provisions allowing for *advance rulings* and for *non-taxable assessments* are two which stand out. A system of *advance rulings* permits the Commissioner to issue formal statements on the efficacy for tax purposes of particular arrangements which taxpayers are about to undertake. Such a system operates successfully in Canada and the United States and allows taxpayers to be more certain of the tax consequences of particular arrangements before committing themselves to these arrangements. In this regard it should be noted that the Commissioner has indicated that he is prepared to give rulings on the application of the new general anti-avoidance provision (Part IVA).⁷³ However, without legislation supporting the Commissioner's good intentions, these rulings must remain unofficial and unbinding.

3.8 SUMMARY OF FINDINGS

With the view to reducing the opportunity for evasion there appears to be considerable scope for improving the tax collection practices of the Australian tax system. Changes could be made to extend the principle of deduction of tax at source. At present this principle only applies in respect of "salary and wages" and even then not all payments for a person's labour are subject to tax. Deduction of tax at source should be required in respect of all payments which are substantially for the labour of a person irrespective of whether the recipient is an employee. Instalments should also be required from interest, dividends, royalties, annuities, mining rent and trust income. Where it is not practical to require income tax deductions at source, improvements ought to be made to the information reporting requirements. Changes such as those to take effect from 1 January 1983 (or at a time thereafter when the appropriate

legislation has been enacted) in the United States might be reviewed. These new information reports cover interest payments, securities and commodity transactions effected by brokers, payments of US\$600 or more as remuneration for services (other than wages), payments of US\$5,000 or more for sales and tips.⁷⁴ Extension of the principle of deduction of tax at source in this way would reduce the opportunity for evasion and it may also have other effects which are beneficial. It is likely to lead to increased willingness of taxpayers to submit returns because deduction of tax at source usually results in slight overtaxing. It would also improve equity between taxpayers by bringing tax payments into closer temporal alignment. It does not seem practicable to extend the above principle to income derived by way of rent or from a business, trade or profession. Equity may be improved however, by requiring instalments of provisional tax and by requiring any underpayment of provisional tax to be made good soon after annual assessments are issued rather than with the next payment of provisional tax.

Present record keeping requirements also appear to be inadequate. Even qualified accountants would disagree if asked to translate the present so-called requirements into a specific set of records. The present lack of regulation is likely, in particular instances, to lead to at least some evasion. One way of reducing the likelihood of evasion is to compel all taxpayers to keep at least some minimum set of accounts. The set, such as that outlined by the Radcliffe Commission in 1955, could be prescribed by the Act. If no minimum set of records is required then the Commissioner should be able to determine what records have been kept and, perhaps, what accounting procedures have been adopted in preparing the annual returns. Tax assessors would, on the basis of the answers to such questions, be in a better position to decide whether further investigations of a taxpayer's affairs were warranted.

Findings regarding the adequacy of resources used to detect evasion must be tentative because of the lack of independent evidence that is available. The Reports of the Commissioner of Taxation are, understandably, guarded in discussion of the methods which are used to detect evasion. These Reports do give some information on enforcement activities but the information available does not suggest that evasion is decreasing. This could indicate weaknesses in the methods used and/or insufficient resources used to detect evasions. While the Reports tend to indicate the latter one should be wary of accepting this too readily. Claims by the Commissioner for more staff might conceal the real problem - antiquated and inadequate methods used. Certainly it would seem that more use should be made of regional offices and more use should be made of computer technology in selecting taxpayers for investigation for possible evasion.

The review of the penalty structure also revealed weaknesses in the control system. For instance the apparent smallness of the amount of most penalties and the fact that most penalties are expressed in fixed dollar terms would not seem to deter would-be invaders. It might be argued that penalties have been left low so as not to cause too much friction with taxpayers; i.e. that compliance is based on co-operation rather than coercion. However, a more likely explanation is that penalties are small because of the impact of inflation on the fixed dollar limits which have been set many years ago, in some cases in the early 1940's. But, before major changes are made to the penalty structure, there should be an empirical investigation of the effects of particular penalties on taxpayers' behaviour. It is possible that increased penalties may increase evasion rather than reduce it. Until evidence is obtained regarding taxpayers' responses to the effects of

particular penalties one can only be speculative. Improved compliance might best be achieved by normative appeals rather than increased penalties. Consideration should be given to (1) the notion of having a range of different types of penalties which can be imposed for a particular offence; (2) rewarding compliance, as well as punishing offenders; and (3) rewarding persons who provide information which results in the conviction of offenders. A provision of the latter type presently exists in the United Kingdom. Section 32 of the *Inland Regulation Act* 1890 provides that:

The Commissioners may at their discretion reward any person who informs them of any offence against any Act relating to inland revenue or assists in the recovery of any fine or penalty, provided that a reward exceeding fifty pounds shall not be paid in any case without the consent of the Treasury.

Some use is still made of this provision. However, it is likely that it would be more useful if the maximum reward payable at the discretion of the Commissioners had been gradually updated from its initial level of £50, set in 1890. In the United States informers are paid a percentage, at present 10%, of the tax and penalty collected.

A number of the administrative provisions of the Act also require amendment. Provisions relating to returns, objections and appeals and lack of provisions dealing with advance rulings and non-taxable assessments all require attention. It is easy to understand why some taxpayers who experience administrative difficulties with the tax system might be motivated to evade tax. For instance, if a taxpayer has waited for a year or more to have an assessment issued, or an appeal considered, he is likely to be quite dissatisfied with the tax system. At a future time this might encourage him to evade. For instance if he is unsure whether a particular amount is assessable as income he might, rather than enquire,

simply omit it from his return. It seems that reform of many of the administrative procedures is overdue. Not only would this improve equity but it might also reduce evasion.

FOOTNOTES TO CHAPTER THREE

1. Robbins, L., "Interpersonal Comparisons of Utility: A Comment" *Economic Journal*, Vol.48, No.192, p.635.
2. *State of South Australia and Ors v Commonwealth of Australia* (1942) 2 AITR 273.
3. Simon's Taxes "Introduction, Procedure, Schedules A, B & C", Third Ed., Vol.A, Butterworths.
4. Taxation Review Committee - Full Report. Canberra: Australian Government Publishing Service, 1975, at para. 22.97.
5. *Ibid*, paras 22.99 and 22.102.
6. *Australian Federal Tax Reporter*, No.436, 1981, p.5.
7. *Ibid*, p.5.
8. See "Information Paper on Cash Payment Tax Evasion Measures" accompanying 1982 Budget Speech.
9. *Ibid*, p.8.
10. *Asprey Committee, op. cit.*, para. 22.123. Specifically it was suggested that instalments of provisional tax be paid one third on 30 November and the balance on 31 May. Separate payment of the shortfall was to be on 30 September following the end of the year of income.
11. *The Tax Equity and Fiscal Responsibility Act of 1982*, Ernst and Whinney Booklet, 19 August 1982, U.S.A., at p.31.
12. Murray, A.P., "A Proposal for Cumulative Withholding", *National Tax Journal*, XV June 1962, pp.184-193 at p.188.
13. *Re Prince: Ex Post the Bankrupt* (1961) ALR 889.
14. By letter dated 2 April, 1981.
15. *59th Report of the Commissioner of Taxation*, Canberra: Australian Government Printer, 1980, p.7.
16. *Asprey Committee, op. cit.*, paras 20.80 to 20.82.
17. *Ibid*, para. 20.82.
18. *57th Report of the Commissioner of Taxation*, Canberra: Australian Government Printer, 1978. Parliamentary Paper No.1, 1978, p.4.
19. *Ibid*, p.5.
20. *Ibid*, p.7.
21. *59th Report of the Commissioner of Taxation*, Canberra: Australian Government Printer, 1980, p.4.

22. *Ibid*, p.54.
23. *60th Report of the Commissioner of Taxation*, Canberra: Australian Government Printer, 1981, p.15.
24. "The Taxpayer Compliance Measurement Program: The Backbone of the Audit Selection System", *The Tax Adviser*, Oct. 1978, pp.605-607 at p.606.
25. See *59th Report of the Commissioner of Taxation*, *op. cit.*, p.5.
26. See *61st Report of the Commissioner of Taxation*, *op. cit.*, p.5.
27. Reported in *Taxation in Australia*, September 1981, p.276.
28. See *CCH Federal Tax Reporter*, Report No.351, 1979, pp.2-3.
29. The Act requires that a Justice of the Peace must be satisfied by information on oath that there are reasonable grounds for suspecting that there is, in any place, anything as to which there are reasonable grounds for believing that it will afford evidence as to the commission of any offence against the laws of the Commonwealth.
30. K.J. Burges and J.C. King, "Rights of Taxpayers and Their Agents to Disclose and Obtain Information". Paper presented at the Australian Society of Accountants' (Newcastle Branch) Annual Conference, Singleton, May 1979.
31. *Ibid*, p.9.
32. See in particular the judgment of Mason, J. in *FCT v Smorgon* 79 ATC 4039 at p.4055.
33. *Ganke v FCT* 75 ATC 4097.
34. K.J. Burges and J.C. King, *op. cit.*, p.506.
35. *FCT v ANZ Banking Group Ltd* (1979) 9 ATR 483.
36. *Ibid*; see Mason's judgment at p.4055.
37. *The Taxpayer*, 13 December 1980, p.369.
38. D.G. Hill, "The Crimes (Tax Offences) Act - A Critical Analysis" *Taxation in Australia*, April 1981.
39. *Ibid*, p.662.
40. To this end the *Special Prosecutors Bill* 1982 was introduced into Parliament on 8 September, 1982.
41. See *CCH Australian Federal Tax Reporter*, Report No.471, 1982, at p.4.
42. The following description of a "bottom of the harbour scheme" comes from the Fourth Interim Report of the Costigan Royal Commission into the Activities of the Federated Ship Painters and Dockers' Union:

"The implementation of the scheme involved 'cashing up' the target company. The target company was, as is frequently the case, a trading company conducting a legitimate business. The shareholders of the target company usually decided to continue the business, albeit under a different corporate structure. In this case, as in others, the following steps were taken to allow that to occur:

(a) A new company was incorporated, often using the same name as the old but with a modification that would be unlikely to suggest it was any different to the old company so far as the customers [were] concerned, and which would satisfy the Corporate Affairs Authorities that it was sufficiently different to allow registration. An example, not drawn from any actual case so far as I am aware, is 'Blackacre Pty. Ltd.', being the name of the target company, and 'Blackacre (Aust.) Pty. Ltd.' being the name of the new.

(b) To facilitate this procedure the name of the target company was often later changed to something quite unlike its former name. In the example, Blackacre Pty. Ltd. may become 'Zebra No.100 Pty. Ltd.'.

(c) The assets and liabilities of the target company were then transferred to the new corporate entity, leaving, at the end of the day, a target company with only cash in the bank. The amount of cash in the bank was equal to the accumulated profits, plus the current year profits (if any). The cash in the bank reflected that equation, and it was on that amount that the percentage constituting the promoter's commission was calculated. The total amount of cash in the bank was the money that was then used to finance the purchase of the shares.

(d) The financing of the shares was achieved by the money being withdrawn from the bank, sometimes by the original directors of the target company, sometimes by the new directors, and paid either directly to the party acquiring the shares, or indirectly to a 'financier' who promptly lent the money to the party acquiring the shares. It is clear that was unlawful, whether done directly or indirectly, since it was in breach of sec.67 of the *Uniform Companies Act*.

(e) The removal of the money from the target company may have been characterised in the books of account as a payment of dividend; or as a loan; or as an inter-company transaction; or the books of account may have disappeared so that no record remained of how it was treated. (The last option was also a breach of the *Uniform Companies Act*, particularly sec.161A, which required companies to maintain proper accounts.)

(f) Since the money was used to acquire the shares it followed that the cash was no longer available to refill the coffers of the target company. The cash had been distributed to the original shareholders and to the promoter who both applied the money to their own purposes. Since it could not possibly be repaid, the company was thus left without any assets. At best it had a debt due to it from the financier which it wrote off as a bad debt. In a series of schemes of this nature on which I have taken evidence, 2 financiers were consistently used in more than 120 cases and in every case the debt constituted by the loan was written off as a bad debt. Since the promoter well knew the purpose for which the money was to be used it followed that in advance he knew not only that the

loan was for an illegal purpose, but that it would be irrecoverable.

The net effect of these machinations was to leave the target company without the assets to pay the taxation debts."

See CCH, *Australian Federal Tax Reporter*, Report No.472, 1982, p.6.

43. See *Financial Review*, 25 August 1982, p.8.
44. *61st Report of the Commissioner of Taxation*, Canberra: Australian Government Printer, 1982, p.21.
45. *Ibid*, p.13.
46. *Australian Income Tax Weekly Summary*, Butterworths, 26 July 1982, No.32, p.1.
47. Section 246 of the *Income Tax Assessment Act 1936* as amended, prevents a Court from mitigating the minimum penalties imposed under the act.
48. For instance, see 11 TBRD Case L66.
49. *Australian Income Tax Weekly Summary*, Butterworths, 20 August 1982, No.36, p.1.
50. See 8 TBRD Case H50.
51. *Karaskas v Kelton* 81 ATC 4122.
52. See s.226(4) of the Act. It prevents taxpayers from being prosecuted under s.226(2) for a particular matter if they have been penalised for that same matter under s.223.
53. *Alva Natona Pty Ltd v FCT* 81 ATC 4443.
54. *Ganke v DFCT (No.2)* 82 ATC 4474.
55. Average weekly earnings in 1941/42 were \$11.20 and in 1981/82 were \$328.70.
56. R.D. Schwartz and S. Orleans, "On Legal Sanctions", *Chicago Law Review*, 1967, Vol.34, pp.274-300.
57. *Cyprus Mines Corporation v FCT* 78 ATC 4468.
58. See CCH *Federal Tax Reporter*, pp.51666-7.
59. *Rabinov and Anor v FCT* 82 ATC 4517.
60. *Scanlon (DFCT) v Swan* 82 ATC 4402.
61. *Aoun v DFCT* 82 ATC 4195.
62. *The Times*, 26 July 1980.
63. N. Friedland *et al*, "A Simulation Study of Income Tax Evasion" *Journal of Public Economics*, 1978, pp.107-116 at p.113.

64. *Asprey Committee, op. cit.*, para. 22.54.
65. *Ibid*, para. 22.48.
66. *The Mercury*, 10 July 1981, p.11.
67. *The Australian Accountant*, August 1977, p.457.
68. *FCT v Reynolds* 81 ATC 4131.
69. *FCT v Bevz* (1981) 11 ATR 776.
70. *Australian Income Tax Weekly Summary*, Butterworths, No.36
20 August, 1982, p.3.
71. Resolved by Boards of Review (47), by agreement between the parties
(13,384) and by withdrawals by taxpayers (4,053).
72. *59th Report of the Commissioner of Taxation, op. cit.*, p.4.
73. *Taxation in Australia*, August 1982, p.185. Record of the Taxation
Liaison Committee Meeting held 11 am on Monday, 21 June 1982 at the
Sydney Taxation Office.
74. *The Tax Equity and Fiscal Responsibility Act of 1982, op. cit.*,
pp.33-34.

CHAPTER FOUR

OPPORTUNITIES FOR TAX AVOIDANCE IN THE AUSTRALIAN TAX SYSTEM

4.1 INTRODUCTION

Inevitably some avoidance will occur because there are defects in the wording of specific provisions and remedial action can only be taken when these defects are exposed. However, other forms of avoidance will occur because there are fundamental weaknesses in the tax system itself. These forms of avoidance can, to some extent, be anticipated. It is the purpose of this chapter to analyse the Australian tax system, using the structure given in Table 2.4, to see where the tax system itself provides scope for tax avoidance.

4.2 OPPORTUNITIES TO SPLIT INCOME WITH OTHERS

Income splitting only has tax advantages where it is possible to transfer income to others who will pay less tax. Thus high income earners who pay tax under a progressive rate structure will always find it advantageous to split income with others. The greater the degree of progression the greater the advantage. Given the rate structure it is easy to calculate the tax that can be avoided once income is split with others. Table 4.1 shows, for example, for the year of income ended 30 June 1983, the tax avoided by an Australian resident taxpayer who splits income with another person who otherwise has no income.

The mere fact that a rate scale is progressive does not mean that there will be avoidance by income splitting, but it does ensure benefits for those who can find ways of splitting income with others. Other

TABLE 4.1

Tax Avoided by an Australian Resident Taxpayer who,
after Transferring One Dollar of Income, has a Taxable
Income Greater than \$35,788

<i>Taxable Income of Transferee*</i>	<i>Tax Avoided 1982/83 Rates</i>
Less than \$ 4,462	60.0 cents
\$4,463 - \$17,894	29.3 "
\$17,895 - \$19,500	24.6 "
\$19,501 - \$35,788	14.0 "

*N.B. (i) Where the transferee is a fully dependent spouse of the taxpayer or is a "prescribed person" in terms of Div.6AA of *The Income Tax Assessment Act* 1936, as amended, the tax avoided may be less.

(ii) Where property income is alienated for short periods (*viz.* less than seven years), the tax avoided will be less.

features of the tax system contribute to provide the opportunity for tax avoidance. For instance, a taxpayer with a dependant spouse would not avoid tax if the tax system required the aggregation of income of husband and wife. (N.B. Under the Australian Tax System tax is payable by *individuals* on the income that he or she derives.) Unless the tax system limits the means by which taxpayers can split income, then the incentive to avoid tax, given by a progressive rate structure, is ready for exploitation. Because the Australian Tax System taxes individuals only on income that they derive it seems that the Australian Tax System might be open to avoidance through income splitting. In fact, the Asprey Committee cited five areas of tax avoidance through income splitting, which it considered required the attention of the legislature. These were:

- (i) Income from gifts of capital;
- (ii) Partnerships, inter-vivos trusts and arrangements achieving similar income sharing results;

- (iii) Excessive payments for services or benefits;
- (iv) Alienation of income; and
- (v) Family companies.

Some of the means by which taxpayers avoided tax by splitting income were simple while others involved complex arrangements. The five areas suggested by the Asprey Committee are analysed more fully below.

4.2.1 Income from Gifts of Capital

The outright gift of property confers upon the donee all rights in respect of that property including any right to income. This provides the donor with a simple means of reducing his income. As soon as he divests himself of title in income producing property he divests himself of income. Once title in the property has passed then, in the absence of statutory provision to the contrary, it is the donee who derives the income not the donor. Gifts of capital are, therefore, simple and effective means of splitting income and are means which are likely to have increased in popularity since the Asprey Committee reported. This increase can be attributed to the abolition, on 1 July 1979, of Commonwealth gift duty and the abolition of State duty by two of the three States which had previously imposed it (Queensland, 1 January 1977 and South Australia, 1 January 1980). The only State which continues to impose gift duty is Victoria but in that State no duty is payable where the aggregate of gifts by a donor does not exceed \$15,000 in any eighteen month period and a carefully planned gifting programme can avoid any duty. Example 4.1 shows how gifts of capital can result in avoidance of income tax.

Example 4.1

X has a salary of \$30,000 and also derives \$10,000 income from deposit

of funds in a building society. Tax payable, on a taxable income of \$40,000, for 1982/83 would be \$14,707. If we assume X has a fully dependent spouse who has no separate net income of her own, and that they have dependent children, his liability is reduced by way of a dependent rebate of \$963 to \$13,744. However, if X were to withdraw his investment and make a gift of the funds to his wife who reinvested the funds in an equivalent investment then total tax payable would only be \$11,216

i.e. Tax payable by X on salary of \$30,000	\$9,517
Tax payable by spouse on interest income of \$10,000	<u>1,699</u>
	<u>\$11,216</u>
	=====

Tax avoided in this example is \$2,528 but the amount will be greater if the gift is split between other family members who have no income of their own.

4.2.2 Partnerships, Inter-vivos Trusts and Arrangements Achieving Similar Income Sharing Results

Income splitting through partnerships has been an area of tax avoidance which both the Ligertwood Committee (1961)¹ and the Asprey Committee (1975)² considered required the attention of the legislature. Many partnerships, it seems, were formed solely for the purpose of tax avoidance. The Ligertwood Committee cited one example in which tax was reduced by A£19,549 to A£7,710. This was achieved when a partnership of four brothers increased the size of the partnership by admitting their seventeen children as limited partners. The Asprey Committee was particularly concerned with partnerships which split income produced by the occupational efforts of one person:

The taxation treatment of family partnerships should not depend simply on the existence of a document which, as a

matter of form, satisfied the requirements of the law of partnership but which readily presents itself as a vehicle for income-splitting by distributing the profits in arbitrarily determined proportions to relatives whose services (if any) in the partnership activities and/or whose capital or property contributions are not commensurate with the remuneration or share of profits received.³

If care is taken it is not difficult, for tax purposes, for families to establish partnerships. These enable many businesses to be carried on by means which result in less tax being payable than would otherwise be the case. The potential for tax avoidance in this way is shown in Example 4.2 which assumes a simple partnership of husband and wife.

Example 4.2

X is a plumber and is about to commence business. He has a fully dependent spouse, and they have dependent children, none of whom derive income of their own. He decides to admit his wife to the business as an equal partner. Tax avoided as a result of this decision will depend upon a number of factors including the level of income. Set out below is the tax payable for 1982/83 given three different income levels:

<i>Tax Payable by Partners 1982/83</i>				
<i>Level of Income</i>	<i>Sole Trader</i>	<i>Partnership</i>	<i>Tax Avoided</i>	<i>b/a%</i>
	(a)	(b)		
\$ 20,000	\$ 3,954*	\$ 3,397	\$ 557	86
\$ 50,000	\$19,744	\$14,434	\$5,310	73
\$100,000	\$49,744	\$41,413	\$8,331	83

[*After dependent spouse rebate of \$963.]

The only section directed at tax avoidance through partnership formation is s.94 which, in effect, provides that where a partner lacks real and effective control and disposal of his share of partnership income that income is subject to a special rate of tax (50% for 1982/83). The section has had little effect because the Courts have decided that once legal ownership in funds is vested in a partner then he has the requisite

control and disposal. Thus, in the above example, if both partners actually received their shares of the partnership income they would be regarded as having real and effective control of the funds irrespective of how family or other commitments influence the disposal of the funds.

Income of a family business can be split with infant children if a trust is used and where income distributions are limited to \$1,040 per child per annum no tax is payable on those distributions. Income distributions of any amount can be made to infant beneficiaries but where distributions exceed \$1,040 tax becomes payable. Further, provided beneficial ownership has passed to the children it is not necessary that the distributions be paid over to them. Control of the funds can remain with the trustee or parent. In fact, it is a common feature of trusts that the trustee retains control over an infant beneficiary's income. Greatest scope for tax avoidance exists if discretionary trusts are used. These permit trustees to consider beneficiaries' individual circumstances each year before distributing trust income. Trustees can vary annual distributions so that overall tax liability of a family is minimised. Example 4.3 shows how tax can be avoided if a family business is carried on by the trustee of a discretionary trust.

Example 4.3

X is about to commence business. He has a fully dependent spouse and three infant children, none of whom has a separate income of his/her own. Tax avoided as a result of using a discretionary trust is shown below assuming three different income levels.

Tax Payable using a Discretionary Trust 1982/83

Level of Income	Sole Trader (a)	Trust ³ (b)	Tax Avoided	b/a%
\$ 20,000	\$ 3,954	\$ 2,440	\$ 1,514	62
50,000	19,744	12,999	6,745	66
100,000	49,744	37,433	12,311	75

Again it is not difficult to establish, for tax purposes, that a business is carried on by a trustee. Nor is it difficult to transfer an existing business to a trustee. It is also possible for a trustee to carry on the business of a professional practice if he is qualified to carry on that business in his own right. Different families can join together to carry on business through a trust structure if a unit trust is used. Figure 4.1 illustrates one of many possible structures which could be used to allow families to join together.

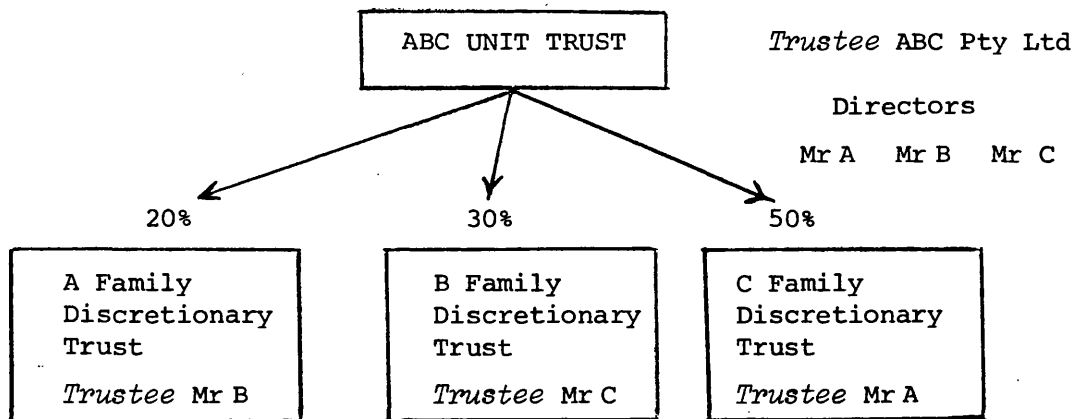


FIGURE 4.1: Possible Business Structure for Families Wishing to Carry on Business Together.

In the above structure the company, ABC Pty Ltd, carries on business, as trustee of the ABC Unit Trust, and distributes income in the fixed shares to the family trusts. The trustees of the family trusts then use their discretion to distribute the income within the respective families. Use of a similar structure was made in *Phillip's Case*,⁴ though in that

case many more families were involved than the three indicated above. Phillips was a partner in a large firm of chartered accountants which caused a unit trust to be formed to take over from the partnership various staff, plant and equipment. These were then made available to the partnership on payment of service fees. These fees were commercially realistic and enabled the unit trust to end each year with a profit. The net income of the service trust was distributed to the unit holders who were, in almost all instances, the trustees of the respective partner's family discretionary trusts. The Commissioner of Taxation was unable to deny the taxpayers the advantages they derived from this arrangement even though the acquisition of trust assets was, in effect, financed by partnership funds.

One section of the Act which has been enacted to prevent income splitting through family trusts is s.102(1) which seeks to deny the tax advantages from the creation of trusts for children of the settlor who are unmarried and under the age of twenty-one. However, the section has been largely defective because it applies only where the settlor is also the parent of the infant beneficiaries. The section does not apply where someone other than the parent creates the trust even though the settlement monies are nominal and the parents later add substantial funds to the trust that has been created.

The most recent report of the Commissioner of Taxation (61st Report) outlines two other ways that trusts have been used to avoid tax:

... Trading or investment income is generally diverted through a chain of discretionary trusts to persons associated with the promoter, who were not expected to incur a tax liability on that income. The first trust in the chain would, however, not be out of pocket. That trust, or an associate, would be reimbursed in a purportedly non-taxable form.

These arrangements have been found to be contrived, circular and lacking in commercial purpose. Promoters

claimed nevertheless that Part IVA did not apply on the ground that a tax benefit as defined in the legislation was not derived by beneficiaries of the particular discretionary trusts used in the stripping arrangements.

More elaborately-structured trust stripping arrangements introduced chains of overseas trusts for the intended purpose of attributing to the relevant trust income a source out of Australia. In other cases, companies allegedly exempt from Australian tax by virtue of provisions in double taxation agreements were made beneficiaries of trust income.

and

Trusts have also been used to avoid or minimise taxation by means of overseas beneficiaries. In one kind of arrangement, trust income is allegedly distributed to a varying number of overseas beneficiaries in sums less than the minimum taxable amount. Under another method, trust income in the form of interest is 'distributed' to overseas beneficiaries. It is claimed that the tax liability on the trust distribution is limited to the interest withholding tax payable. In both cases, however, the funds remain in Australia. The relevant distribution is merely credited to the non-resident beneficiary's account in the trust books and the beneficiary purportedly lends the funds back to the trustee or to individuals or entities associated with the creation of the trust. It appears in many cases that the overseas beneficiaries are unaware both of the purported distribution and the lending of the funds.⁵

Other income splitting arrangements to meet with the wrath of the Asprey Committee included interest free loans to relatives and leases to relatives at token rents. Both of these devices split income to relatives by means which would not have been adopted by parties dealing at arms length.⁶ The Act does not contain any provisions which prevent these latter arrangements.

4.2.3 Excessive Payments for Services or Benefits

Excessive payments to relatives for services rendered, benefits received or goods supplied were another means of income splitting which the Asprey Committee found objectionable.⁷ Such payments did not alter the gross income earned by a particular family though they did reduce the family's overall tax liability as Example 4.4 indicates.

Example 4.4

X carries on business as a sole trader and net income for the year is \$30,000. His tax liability can be reduced if he decides to pay salaries of \$10,000 to his wife, and \$5,000 to his son aged 18 years. (N.B. It is assumed his two dependents have no other income.)

*Tax Payable by Sole Trader who makes Payments
to Relatives (1982/83)*

	<i>No Salaries Paid</i>	<i>Salaries Paid</i>
Tax payable by X	\$8,554	\$3,232
Tax payable by X's Spouse	-	1,699
Tax payable by X's Son	-	165
	<u>\$8,554</u>	<u>\$5,096</u>
	=====	=====

Tax avoided by paying salaries is $\$8,554 - \$5,096 = \$3,458$.

Tax payable after salaries are paid is 60% of that payable in the absence of salaries. The Act contains a provision (s.65) which tries to prevent tax avoidance by these means. Section 65(1) authorises the Commissioner to deny or reduce deductions claimed for payments made to "associated persons". Only those amounts which, in the opinion of the Commissioner, are reasonable reward for services rendered are allowable deductions for tax purposes. It might be thought by some that where the payment is "excessive" then the taxpayer has *evaded* tax rather than *avoided* it. The proper classification for what has been done will depend upon the facts of each situation and the intentions or motivations of the parties.

Section 65 has its defects. Firstly it is a difficult provision to police because the Commissioner cannot hope to know how much effort has been contributed by particular family members. Secondly, the definition of an "associated person" in s.65(1D) is inadequate. Though

it extends to payments to close relatives made by a sole trader or a partnership it does not cover payments made to family members where the business is carried on by a trust.

4.2.4 Alienation of Income

Alienation or assignment of income refers to the transfer of rights to receive income from property without the transfer of legal title in the property itself. Such assignments are possible because the law attaches proprietary rights to the right to receive income from property as well as to the property itself. Though it is possible in law to assign both past and future income it is only possible to assign rights to future income for tax purposes. But even then not all future income can be assigned; for instance, wages and salaries cannot be assigned because the requisite proprietary rights do not exist. Table 4.2 indicates in broad terms which types of income can be assigned for tax purposes.

TABLE 4.2

Income Rights which may be Effectively Assigned
for Tax Purposes

<i>Type of Income</i>	<i>Capable of Assignment Yes/No</i>
Interest	Yes
Rent	Yes
Royalties	Yes
Partnership Profits	No*
Trust Income - Fixed Trust	Yes
- Discretionary Trust	No
Dividends	No
Wages and Salaries	No

*Partnership profits *per se* cannot be assigned though one can divest oneself of partnership income by assigning part or all of one's entire interest in the partnership.

The Act does not prevent income from being assigned but it does require (Div.6A) that assignments operate for a period of at least seven years if the assignee is to bear the liability for tax. If an assignment is for a period of less than seven years then, unless the property itself has also been assigned, tax will be payable at the rates applicable to the assignor.

4.2.5 Family Companies

Family companies were singled out for attention by the Asprey Committee mainly because they were used to pay dividends to family members out of proportion to capital subscribed by them:

One type of transaction which may constitute an income-splitting device by means of a family company can be seen in the acquisition of shares by a relative of the family which (i) entitle the holder to a share in the distribution of the company's profits disproportionate to the amount of capital subscribed by him, or (ii) enable those in control of the company to declare dividends in respect of his shares without distributing dividends to other shareholders, or (iii) enable those in control to declare differential dividends to selected shareholders.⁸

Because companies have a separate legal identity proprietors can transfer their businesses to companies, assume control of those companies and allow family members to participate in distribution of dividends. Table 4.3 shows how the issue of different classes of shares in a typical family company allows income to be split to different family members yet leaving the original proprietor in control of the business. Typically the 'A' class share is held by the proprietor who could also hold the 'B' class shares which have been allotted to him in satisfaction of the sale price of his business. The proprietor can, therefore, maintain control of the business, resist moves to dislodge him as managing director, receive dividends and acquire the business should the company ever be liquidated. The proprietor takes income by way of salary or director's

TABLE 4.3

Possible Share Structure of a Family Company

<i>Class of Share</i>	<i>Number Issued</i>	<i>Beneficial Shareholder</i>	<i>Rights Attaching to Shares</i>
'A'	1	Proprietor	Right to be Managing Director
'B'	9199	Proprietor	Right to Vote Right to Return of Capital Right to Dividends
'C'	200	Spouse	Right to Dividends
'D'	200	Child 1	Right to Dividends
'E'	200	Child 2	Right to Dividends
'F'	200	Child 3	Right to Dividends

fees allowing dividends to be declared in respect of shares held by other family members. The potential benefits that can be obtained from such an arrangement are shown in Example 4.5.

Example 4.5

A taxpayer, X, sells his business to a company. Below is a comparison of tax he would have paid had he continued to operate as a sole trader and that which will be paid under the new structure. The results are based on three different income levels and rates of tax are those for 1982/83. It is further assumed that, under a corporate structure, X takes a salary of 50% of business income, his wife takes a salary of 25% and dividends are distributed to minimise total tax payments. Shares are held by the taxpayer (X), his wife and by a trustee for their three children.

*Comparison of Tax Payable by Sole Trader and
under a Company Structure for 1982/83*

<i>Level of Income</i>	<i>Sole Trader (a)</i>	<i>Company (b)</i>	<i>(a)-(b)</i>	<i>b/a%</i>
\$ 20,000	\$ 3,954	(i) \$ 4,164	\$(210)	105
50,000	19,744	(ii) 15,432	4312	78
100,000	49,744	(iii) 39,424	10320	79

	X	Spouse	Company	Children
(i) Taxable Income	\$10,000	\$5,000	\$5,000	\$180 each
Tax Payable	1,699	165	2,300	-
(ii) Taxable Income	25,000	12,500	12,500	\$450 each
Tax Payable	7,217	2,465	5,750	-
(iii) Taxable Income	50,000	25,000	25,000	\$900 each
Tax Payable	20,707	7,217	11,500	-

Other purposes can also be achieved with the distribution of shares, shown in Table 4.3, because the declaration of dividends is at the discretion of the directors who can allocate dividends between family members so as to reduce the overall tax burdens.

4.3 OPPORTUNITIES TO CONVERT INCOME INTO CAPITAL

Conversion of income into capital is another means by which tax can be avoided. Strictly speaking though, the process is not one of converting income into capital because once income is derived, tax liability has accrued and one can only escape payment of tax by *evading* it. If tax is to be *avoided*, steps must be taken prior to the derivation of income. Thus, the phrase "converting income into capital" refers to the situation where steps are taken to ensure that a potential income receipt will be regarded as capital when the relevant transaction occurs.

Sometimes amounts are regarded as "income" simply because of the *form* of their receipt. In such a case a change in the form of receipt can change its character. For instance, certain annuities are income only because they are received periodically. Commuting annuity rights to a lump sum can change the character of those receipts to capital. However, where retirement pensions are involved, the decision to commute pension rights soon after retirement may have tax implications under s.26(d).⁹ Where amounts are income by *nature* rather than by form, nothing can be done to change their character. Nevertheless, tax might still be

avoided - by having another taxpayer derive that income. Steps must be taken *before* the relevant amount accrues to allow it to be received by that other taxpayer. These are the general principles behind tax avoidance schemes in this area. Some of the schemes to emerge and which are still available are briefly mentioned below.

4.3.1 Disposal of Property

Many circumstances influence the character of proceeds flowing from the disposal of property. These include the type of property disposed of, the length of time it was held, the vendor's occupation and the frequency of sales of like property by the vendor. For instance, a real estate agent who buys and sells land at a profit is likely to be liable for tax on that profit. On the other hand if a market gardener had bought and sold the land after using it in his business then it is unlikely that any amount would be taxable. In Australia the proceeds from sale of property will be regarded as *income* if the property is regarded as trading stock of a business (s.25). It does not follow that if the property is not trading stock profit on sale will not be taxable. If the proceeds from sale are regarded as capital in nature the profit on sale might still be assessable. The first limb of s.26(a) brings to tax the profit on sale of property where it was acquired for the purpose of resale at a profit. The decision in *William's Case*,¹⁰ however, shows how liability to tax from the application of this provision was avoided. Williams was a real estate agent who was advised that he would be liable for tax if he sold property he had acquired. Instead, he transferred his interest in the property, by way of unsolicited gift, to his wife. She later sold it for a profit and the Commissioner of Taxation sought to assess her on that profit but his attempts failed. The property was not a business asset nor was it acquired for the purpose of resale at

a profit. The Full High Court decided that acceptance of the gift by Mrs. Williams could not be regarded as an acquisition of property with a purpose of profit making. In fact the Chief Justice would not accept that an unsolicited receipt of a gift was purposive in any relevant sense. Thus application of s.26(a) was avoided. Consequently, if the realisation of an asset by one member of a family could result in tax being payable steps could be taken to avoid tax by transferring ownership in that asset to another family member. Tax will be avoided if the donee retains the property for a period of at least twelve months. Since *William's Case* legislation has been introduced, in the form of s.26AAA to tax profits on disposal of property which is held for less than twelve months. However, if both the donee and the donor hold the property for at least twelve months before disposing of it then repetition of the steps undertaken in *William's Case* can still result in tax avoidance.

Taxpayers owning natural resources such as sand or timber can also avoid tax provided care is taken. In *Stanton's Case*¹¹ the taxpayer avoided tax on money received from a sawmiller because he entered into a contract which gave the sawmiller "the right to enter land" rather than "the right to cut down specific quantities of timber".

Individuals who enter into restrictive covenants or who give up their amateur status also have the opportunity to avoid tax. Provided these individuals enter into agreements which clearly specify that any monies received are for loss of a capital asset, and that alone, then the amounts are likely to be regarded as capital.

Companies which have ceased to fulfil a useful purpose for their proprietors and which have accumulated capital profits can be exploited in other ways. In *Gibb's Case*¹² shareholders avoided tax by arranging

to receive their shares of capital profits on winding up rather than as dividends of an on-going concern. No tax was payable in these circumstances because s.47 of the Act only extends to liquidation distributions which were "income" in the hands of the company. Liquidation distributions paid out of "capital profits" were not assessable even though distributions out of those profits prior to liquidation would have been taxed in the shareholders' hands. Thus shareholders of private companies who defer their need for capital profits can avoid tax by using the scheme outlined in *Gibb's Case*.

The decision in *McLaurin's Case*¹³ indicates further scope for tax avoidance through conversion of income into capital. In that case the taxpayer received a lump sum in full settlement of a claim for damages resulting from a fire which had commenced on an adjoining property. Damages *claimed* included an amount for loss of income but when settlement was reached the taxpayer agreed to receive a single sum for all claims. The Court decided that, in the circumstances, no part of the sum received was income. The amount received was accepted under a compromise as a single undissected amount and was regarded as consisting entirely of capital. It should be emphasised that advantage can only be taken of the decision in *McLaurin's Case* if the fact situation is substantially similar and this may not always be the case. Similarly, where a taxpayer is allowed an abatement to any payment of a capital nature rather than receive compensation of a revenue nature he can "convert income into capital". This was evident in an English decision¹⁴ involving a steamship company which, shortly after acquisition, placed a motor vessel in the hands of repairers for overhaul. The time stipulated for overhaul was exceeded and the owners claimed damages for loss of profits. It was decided that the amount received was income but Lord Sands explained how this result could have been avoided: *viz.* if the owners had accepted

an abatement to the cost of repairs the amount of the abatement would have been regarded as capital.

Over the last few years a number of other tax avoidance schemes, converting income into capital, have been successful, e.g. "trust stripping", "Curran schemes" and the like. These have not been outlined in this part as representing opportunities for tax avoidance because remedial legislation has been enacted (see Table 4.5).

4.3.2 Form of Receipt

Receipts which are income by nature remain income irrespective of the form of receipt. Thus, it does not matter whether wages, rent or interest are received periodically or by way of a lump sum. However, not all items which are income for tax purposes are income by nature. Sometimes amounts such as retirement pensions are regarded as income because of the form of receipt. In these circumstances it is possible to avoid tax by taking steps to alter the method of receipt. However, some tax might be payable because s.26(d) requires that 5% of a lump sum received *in consequence of retirement* must be included in a taxpayer's assessable income. Whether tax is paid depends upon whether the taxpayer's taxable income (for the 1982/83 financial year) exceeds \$4,462. Thus if a taxpayer retires early in the financial year and the only amount of *assessable income* he has is the amount caught under s.26(d) no tax will be payable unless the lump sum exceeds \$89,240 (i.e. $\$4,462 \div 5\%$). Further, where income can be deferred and paid in consequence of retirement only 5% will be subject to tax under s.26(d) rather than the whole amount under s.25(1). For instance, in *Reseck's Case*¹⁵ the taxpayer successfully argued that severance pay, based on the number of shifts worked, was taxable under s.26(d) even though it was also income under s.25(1). Section 26(d) does not extend to lump sum payments of annual

leave or long service leave, though it does apply to lump sum superannuation payments, sick leave, bonuses, severance pay and gratuities.

4.4 EXEMPTIONS FROM THE TAX BASE

Exemptions to the tax base contribute to the level of tax avoidance. The most important exemption in Australia is the failure to tax capital gains. Other exemptions also exist and these include the omission to tax all ex-Australian source income derived by residents, the failure to tax all fringe benefits and all voluntary payments. These exemptions and some others are now discussed in some detail.

4.4.1 Ex-Australian Source Income Derived by Residents

Although the scheme of the Australian taxing statutes is to tax residents on world wide income it is possible to avoid tax on certain income by locating its source outside Australia. This results from the operation of s.23(q) which was introduced, apparently with the intent of preventing double taxation of ex-Australian source income derived by Australian residents. In fact its operation can result in no tax being paid at all. This was highlighted by the decision in *French's Case*¹⁶ which emphasised that income was exempt from tax under s.23(q) provided it was "not exempt from tax" in the source country. French had worked temporarily in New Zealand and the income he earned was subject to tax there. However he did not earn sufficient income for the year to attract any tax. The question of whether any tax had been paid does not seem to be decisive under s.23(q). Rather the crucial question was whether the income was "exempt from tax" in the source country. The Court decided that the income was *not* exempt from tax in New Zealand and was therefore exempt from tax under s.23(q).

Taxpayers can still exploit s.23(q) but they must be able to locate the source of income outside Australia. This will not be possible for all types of income; for instance, royalties which are outgoings of an Australian business are deemed to have an Australian source. Wages and salaries have their source of income where the work is done. Thus employees who wish to take advantage of s.23(q) must work outside Australia. Arrangements can also be made for interest and rental income to have an ex-Australian source. However, s.23(q) does not apply in all cases where such income is derived.¹⁷ The following example shows how s.23(q) can result in tax avoidance.

Example 4.6

X, an Australian taxpayer, derives wages and salary of \$10,000 and has investible funds which will realise rental income of \$5,000 p.a. He wants to minimise his tax burden. Below is a comparison of tax payable on the assumptions that the property income has an Australian source and an ex-Australian source. It is assumed that the rental income is derived in the New Hebrides and that income tax in that country is payable only where taxable income exceeds \$5,000.

Tax Payable on Incremental Property Income 1982/83

	<i>Aust.Source Income</i>	<i>Ex-Aust.Source Income</i>
Aust. tax on salary of \$10,000	\$1,699	\$1,699
Aust. tax on property income	1,534	-
Ex-Aust. tax on property income	-	-
	<u>\$3,233</u>	<u>\$1,699</u>
	=====	=====

$$\text{Tax avoided} = \$3,233 - \$1,699 = \$1,534$$

Non-residents can also avoid Australian tax by taking steps to ensure that the source of income is outside Australia. If care is taken the source of income can be located outside Australia even if the income

results, in part, from work done in Australia. For instance, in *Mitchum's Case*¹⁸ a film star from the United States received A£16,675 from an Australian firm mainly as a result of work done in Australia producing, directing and acting in a film. Though the work had been done mainly in Australia the Court decided that Australia was not the source of the income. Enough steps had been taken to ensure that the source of the income was outside Australia: payment was to take place outside Australia, the contract was entered into outside Australia, and some of the work was done outside Australia. Other non-residents also avoid tax by closely following what was done in *Mitchum's Case*.

4.4.2 Receipt of Certain Voluntary Payments

Courts have consistently excluded gifts from the conception of income within the meaning of s.25 of the Act. This has allowed some taxpayers to receive certain amounts without tax being payable. For instance, in one case, a solicitor received A£10,000 from a grateful client and successfully argued that the amount was not taxable.¹⁹ In another case a gift of 20,000 shares in a public company from its founder to a former employee was also held to be not taxable.²⁰ The fact that the donor gave the taxpayer the shares in recognition for past services was not decisive. The character of gifts was determined from the standpoint of the recipient and whether the gift related to any income producing activity on his part:

What is decisive, in my opinion, is the fact that it is impossible to relate the receipt of the shares by Hayes to any income producing activity on his part.²¹

This test is also relevant in determining whether prizes, awards, proceeds from casual sales or other windfall receipts are "income" for tax purposes.

4.4.3 Fringe Benefits

Fringe benefits are only regarded as income if they are paid in relation to an income-earning activity on the part of the employee. However, under s.26(e) of the Act, such benefits may be subject to tax as a special class of assessable income. This section applies to benefits whether given in cash or kind and whether given directly or indirectly in relation to employment or services rendered. Though fringe benefits may be subject to tax under either s.25(1) because they are income, or s.26(e), scope still exists for tax avoidance. It is doubtful whether s.26(e) extends to tax fully all benefits given by a taxpayer's employer to family members or whether it extends to tax fully all benefits accruing to the employee which he receives as part of his employment.

Further opportunity for avoidance exists because the amount subject to tax under s.26(e) is the value to the taxpayer of the benefit received. However, there are no clear cut rules for determining this value and taxpayers have always been able to give reasons why a market value should be discounted. Fringe benefits have also given taxpayers the opportunity to evade tax either through deliberate undervaluation or deliberate omission of the value of the benefits from their annual returns.

4.4.4 Deferment of Income

Other defects in the Act allow some taxpayers to defer tax. For instance, the Act does not require professional practices to include the value of work in progress in net income for the year. Revenue is not recognised until the work has been completed and transformed into a recoverable debt. Professional practices can defer tax by postponing completion of work until after the end of the year of income. In many cases this may simply mean that all work is done except for invoicing.

Dividend income can also be deferred where one or two holding companies are interposed between the company generating the income and the ultimate recipients. Table 4.4 shows how this is done where two holding companies are used.

TABLE 4.4

How Tax on Dividend Income can be Deferred using Two
Interposed Holding Companies*

<i>No Holding Companies</i>	<i>Latest Date for Payment of Dividends</i>	<i>Two Holding Companies</i>	<i>Latest Date for Payment of Dividends</i>
Company XYZ		Company XYZ	
		Holding Co.1	
Individual Shareholders	30 April 1984	Holding Co.2	
		Individual Shareholders	30 April 1986

*The Table assumes that company XYZ derives income during the year ended 30 June 1983.

Provided the holding companies pass the dividends on then no tax will be payable by them on the dividends and the individual shareholders will have an additional two years before they will be required to pay the tax. Deferral of dividend income has a number of advantages. Given the time value of money it means that the real burden of taxation is reduced. It also allows for greater flexibility in choice of the ultimate recipients of the dividend income. Where shareholders' incomes fluctuate from year to year dividends can be released to shareholders when their incomes are low. The passing of time might also allow for new tax avoidance schemes to come to light or additional shareholders to be found. In the meantime, the proprietors of the companies can have full control over and use of the funds involved.

Taxpayers who carry on business and who recognise income on a cash basis rather than on an accrual basis also defer income, sometimes indefinitely. The decision in *Henderson's Case*²² demonstrated one way of doing this. Henderson was a member of a firm of accountants which had for many years lodged its returns on a cash or receipts basis. Although this meant that tax on accounts receivable was deferred the Commissioner accepted returns on this basis. For the year ended 30 June 1965, the firm lodged its return on an earnings basis omitting accounts receivable at the beginning of the year. These amounted to \$179,000 and as returns for previous years had been based on a cash basis it meant that this change, if successful, would avoid tax ever being paid on the amount of the accounts receivable. The Court felt that it was not proper to consider previous assessments and decided that the correct basis of assessment was an earnings basis.

In respect of schemes contemplated under this heading, taxpayers must now consider the provisions of s.82KK which limit the deduction otherwise available where *all* of the following conditions are met, *viz*:

- (i) a loss or outgoing is incurred by the taxpayer after 19 April 1978 to *an associate* of the taxpayer;
- (ii) the loss or outgoing is deductible; and
- (iii) the deduction, apart from the operation of s.82KK, would be an allowable deduction to the taxpayer in one year of income and not assessable as income to the associate until a later year of income.

One of the effects of this provision is to prevent schemes which involve arrangements under which interest, while not paid to an associate, was accrued and would otherwise be deductible. N.B. The interest would not be regarded as income of the associate until a later year when the interest was paid. The provision also prevents schemes which involved

the payment in advance for goods or services that were to be provided in future years. Because payment had been made the taxpayers would claim deductions for the expense but because the goods or services were not provided by the end of the year of income the associate would not have treated the receipts as income. Application of s.82KK to such schemes means that the deduction for the taxpayer (for the interest expense, the goods or services etc) is deferred until the relevant amount is paid to the associate, i.e. until that amount is regarded as being derived as income.

4.4.5 Deductions for Gifts

Over recent years there have been a number of instances where taxpayers have exploited s.78 of the Act - the section providing deductions for certain gifts. For instance, s.78(1)(aa) allows a deduction in respect of gifts of a value of \$2 or more of property to, *inter alia*, public libraries, public museums or public art galleries in Australia. The deduction allowed is the value of the gift having regard to valuations made by persons accepted as proper valuers and registered with the Department of Home Affairs. One scheme, exploiting this provision, which received publicity involved a group of businessmen who made a gift of a pre-Columbian art collection to the National Gallery of Victoria. The collection was purchased for about \$1 million but was valued for purposes of s.78(1)(aa) at three times its cost. Following the publicity the Government moved to block similar occurrences for gifts made after 15 October 1981.

Another example of exploitation of the gift provisions is evident in *ECT v Coppleson*.²³ The taxpayer, a medical practitioner, on advice from his financial adviser purchased 39,990 shares of \$1 each in his

family company and within two days transferred ownership of those shares, by way of gift, to a public hospital. The Court allowed the taxpayer's appeal though it did limit the amount of the deduction to \$24,000. The fact that the taxpayer was motivated, to some extent, to reduce his tax burden was not sufficient reason to deny him the deduction.

4.4.6 Use of Exempt Status of Certain Bodies and Associations

Section 23 of the Act exempts from tax the income of certain bodies and associations, e.g. (i) s.23(e) exempts the income of a religious, scientific or public educational institution; (ii) s.23(f) exempts the income of a trade union or the income of an association of employers; and (iii) s.23F exempts the income of particular superannuation funds. However, it seems that there have been several tax avoidance schemes which have exploited the exempt status of certain of these bodies. According to a press release by the Treasurer on 24 June 1980, a number of schemes have been used including the following:

A person assigns rights to income to an exempt body and receives in return a capital sum that is, by only the amount of the 'fee' payable, less than the amount of the income.

A person with a crop ready for harvesting (or cattle about to be sold) enters into partnership with an exempt body, which pays to the person a capital amount for its 75 per cent interest in the partnership. The special provisions of the income tax law that apply to variations of interests in trading stock and related property are used to transfer the crop (or cattle) to the partnership for a relatively small amount for tax purposes, so that when the partnership sells the produce, the exempt body's 75 per cent share of the partnership's tax profit is received tax free.

A person enters into successive partnerships with an exempt body. The person has a 99 per cent interest, and the exempt body a 1 per cent interest, in the first partnership. This partnership buys and sells cattle, most of which are traded at little or no profit for a relatively small price. The acquisition of these cattle is claimed to give a relatively low average cost to much more valuable beasts that the

partnership has bought and owns when, as part of the tax avoidance arrangement, the partners go into the second partnership, in which their profit shares are reversed.²⁴

The Government has since enacted a new Division (Division 9C) to prevent schemes which divert income to these organisations or funds and the maximum marginal rate (60¢ in the dollar, for 1982/83) now applies to such diverted income. Schemes which diverted income prior to 24 June 1980, however, were not affected.

4.4.7 Trading Stock Provisions

Normally, when trading stock is disposed of otherwise than in the ordinary course of business, the market value of that stock is assessable. But for partnerships where one or more persons retain a continuing interest of at least 25% in the stock, s.36A(2) allows the stock to be transferred at cost. These provisions have been the foundation of tax avoidance. In a press release, 30 January 1981, the Treasurer gave details of one scheme:

A primary producer has cattle that are worth \$525,000, but the cost of which for tax purposes is \$50,000. The taxpayer enters into a livestock trading partnership with a company which the promotional matter describes as 'having the capacity to absorb large amounts of assessable income'. The taxpayer has a 25 per cent interest in the partnership and the company 75 per cent. The partnership then buys the cattle from the taxpayer for \$500,000 and sells them for \$525,000. After selling expenses of \$25,000 it is left in a break-even cash position.

However, an election is lodged under section 36A(2) of the Income Tax Assessment Act with a view to the cattle being treated as having been sold to the partnership for \$50,000. That means that the partnership has a tax profit of \$450,000 (\$525,000 sale price less deemed cost of \$50,000 and selling expenses of \$25,000). The profit is allocated to the taxpayer (\$112,500) and the company (\$337,500).

The taxpayer's tax position is then - again according to the promotional matter - that he has assessable income of \$112,500 which is to be reduced by commission and management fees of \$40,000 paid under the scheme to another company associated

with the promoter. The taxpayer's assessable income is further reduced by normal operating expenses of \$50,000 leaving a balance of \$22,500 on which tax of \$7,000 might be paid.

The taxpayer's actual financial position is in marked contrast. Against receipts of \$500,000 from the sale of the cattle to the partnership there are the previously mentioned operating expenses of \$50,000 and the commission and management fees of \$40,000. When further reduced by the tax of \$7,000 the taxpayer has a net profit of \$403,000.

The Government has since introduced legislation²⁵ to counter these schemes but the traditional use of s.36A(2) has not been affected. Such schemes are further evidence that the existence of exemptions provides scope for avoidance.

4.4.8 Expenditure Recoupment Schemes

All of the expenditure recoupment schemes including those involving marketing of films, acquiring copyrights, purchasing consumable supplies, carrying out market research, paying commission for collecting assessable income, paying fees for the growing and care of trees and paying fees for procuring sound recordings are further instances of avoidance resulting from exemptions in the tax base. Though the Government has introduced legislation to prevent these expenditure recoupment schemes, it does not alter the fact that the more provisions there are providing exemptions from the tax base or providing special allowances, rebates or deductions, the more scope there is likely to be for tax avoidance.

The 61st Report of the Commissioner of Taxation summarises many of the blatant, artificial or contrived schemes for which remedial legislation has been introduced. These schemes are outlined in Table 4.5 and include official estimates of the tax deductions (or tax expenditures) claimed as well as the tax reduction sought. The total claims for particular schemes listed, excluding claims for the carrying forward

TABLE 4.5

Summary of Tax Avoidance Schemes, now Legislated Against, where the Tax Reductions Sought Exceeded \$10 m.

Income Year	Broad Type of Arrangement	Act incorporating legislation passed to safeguard revenue	Total Deduction Claimed \$m	Tax Reduction Sought (a) \$m
1975-76	Trading stock schemes	<i>Income Tax Assessment Amendment Act</i> 1977	38.2	15.5
		" " 1978		
1976-77	Curran-type schemes	" " 1978	60.6	22.7
		" " (No. 4) 1979		
1977-78	Trading stock schemes	(see 1975-76 for details)	42.2	17.7
	Curran-type schemes	(see 1976-77 for details)	1,193.6	74.3
	Mortgage discharge schemes	<i>Income Tax Assessment Amendment Act</i> (No. 4) 1979		
		" " 1979	129.4	14.6
		" " (No. 4) 1979	241.3	51.2
1978-79	Prepayment of expenses schemes	" " 1979	186.1	53.3
		(see 1975-76 for details)	20.4	10.2
	Trading stock schemes	<i>Income Tax Assessment Amendment Act</i> 1978		
	Division 7 tax schemes	" " (No. 5) 1979	(897.8)	21.6
	Losses generated under schemes in earlier years sought to be brought forward	<i>Income Tax Laws Amendment Act</i> 1979		
		" " 1981		
	Commissions schemes	<i>Income Tax Assessment Amendment Act</i> (No. 4) 1979		
		" " 1979	31.9	12.0
	Curran-type schemes	(see 1976-77 for details)	86.5	21.9
	Depreciation schemes	<i>Income Tax Laws Amendment Act</i> 1979	45.4	17.5
		<i>Income Tax Assessment Amendment Act</i> (No. 4) 1979		
	Film industry schemes	" " "	24.0	11.1
		<i>Income Tax Laws Amendment Act</i> 1981		
	Mortgage discharge schemes	(see 1977-78 for details)	78.9	19.6
	Prepayment of expenses schemes	(see 1977-78 for details)	45.6	18.7
	Gift schemes	<i>Income Tax Assessment Amendment Act</i> 1978	50.1	19.4

TABLE 4.5 (continued)

Income Year	Broad Type of Arrangement	Act incorporating legislation passed to safeguard revenue	Total Deduction Claimed \$m	Tax Reduction Sought (a) \$m
1979-80	Losses generated under schemes in earlier years sought to be brought forward	(see 1978-79 for details)	(126.4)	15.8
	Commissions schemes	(see 1978-79 for details)	46.1	19.7
	Film industry schemes	(see 1978-79 for details)	45.5	20.1
	Primary production schemes	<i>Income Tax Assessment Amendment Act (No.4) 1979</i>	24.7	10.9
	Mining and prospecting schemes	" "	27.5	11.9
	Prepayment of expenses schemes	<i>Income Tax Laws Amendment Act 1981</i>	79.9	30.4
	Trading stock schemes	(see 1977-78 for details)		
		<i>Income Tax Laws Amendment Act 1981</i> (see also 1975-76)	45.5	17.8
1980-81 (incomplete)	Schemes involving rebates in afforestation and off-shore exploration industries	<i>Income Tax Assessment Amendment Act (No.4) 1979</i>	..	24.0
		<i>Income Tax Assessment Amendment Act 1980</i> (Further amendments foreshadowed in Treasurer's statement of 9 February 1982)		

(a) The figures shown as tax reductions sought reflect the tax implications in the relevant year of the respective deductions being allowed in isolation. Where a taxpayer has made claims for deductions generated under two or more schemes in a particular year, the total amount of revenue at risk in respect of that taxpayer may be less than indicated here. Tax reductions that are attributable to deductions in excess of taxable income of the relevant year and sought to be carried forward are not included in amounts in column headed 'Tax reduction sought'.

Source: *61st Report of the Commissioner of Taxation*, Canberra: Commonwealth Govt. Printer, 1982, pp.19-20.

of losses from such schemes, amounted to A\$2,543m (approx. stg£1,500m).

4.4.9 Concessional Tax Treatment for Life Assurance Premiums and Proceeds

Section 82H of the Act was introduced in 1950 to provide, subject to specified maxima, allowable deductions for life assurance and superannuation fund premiums. This concession, converted to a rebate of tax (s.159R) from 1 July 1976, was coupled with s.26(i) which exempted from assessable income any reversionary bonus on a policy of life assurance. These provisions have been exploited over the years and have required amendment in order to prevent further avoidance of tax. Tax avoidance schemes included:

- (i) taking out life assurance policies, paying premiums for only a few years, claiming tax deductions for the amounts paid and then cancelling the policies. Taxpayers would receive a refund of almost all of their contributions and not lose the benefits of deductions at marginal rates of up to 66.7%;
- (ii) taking out short term policies which were promoted on the basis that significant tax free gains would be derived within a relatively short period either by surrendering or obtaining a loan against the policy or by receiving regular payments of bonuses. This type of scheme provided negligible death cover and an annual return at a guaranteed rate.

To prevent such schemes amending legislation has been introduced. Firstly, since 1 January 1973 premiums for life insurance have not been subject to concessional treatment where they relate to *short term* (i.e. less than ten years) policies. Secondly, since 27 August 1982, bonuses and other proceeds of certain *short term* (i.e. less than four years) life assurance policies will now be subject to tax.

4.5 ADEQUACY OF THE ANTI-AVOIDANCE PROVISIONS

4.5.1 Section 260

Since 1915 when income tax was first imposed by the Commonwealth the Act has attempted to prevent tax avoidance by containing a general anti-avoidance provision. From 1936 to 1981 that provision was s.260 which, in essence, provided that every contract, agreement or arrangement which had the purpose or effect of avoiding tax was void, as against the Commissioner. The purpose of the section was, according to paragraph (c), the prevention of tax avoidance. However, in a strict sense tax was avoided whenever an arrangement did not attract every possible future liability and it was clear that the legislature could not have meant the section to operate in that way. To do so would have brought s.260 into conflict with other sections of the Act. The Courts recognised this potential conflict and restricted the operation of the section. But this meant that the Courts were not able to apply the usual rules of statutory interpretation to the section. Alternative rules had to be found and this was a major problem:

The very wide scope of section 260 and its place in the Act produces a paradox which is critical to the interpretation of the provision. Since section 260 is a back-up provision which necessarily overlaps the more specific provisions of the Act, it must live in an uneasy compromise with those provisions. ²⁶

The most significant attempt to find an alternative expression of what was intended by s.260 was the "test" laid down by the Privy Council in *Newton's Case*:²⁷

In order to bring an arrangement within the section, you must be able to predicate - by looking at the overt acts by which it was implemented - that it was implemented in that particular way so as to avoid tax. If you cannot so predicate, but have to acknowledge that the transactions are capable of explanation by reference to ordinary business or family dealings, without

necessarily being labelled as a means to avoid tax then the arrangement does not come within the section.²⁸

Unfortunately this test was not capable of being translated into criteria for determining whether arrangements ought to have been struck down.

The section was still law when this thesis was commenced but was repealed on 27 May 1981. The High Court suggested s.260's repeal as early as 1957 but, apparently, it was not until much later that the Government saw the same need. In June 1979 the Treasurer said, in Parliament, "that he hoped to be able to produce the first draft of a new s.260 during the Budget Session. He noted that the Government has been working extensively on this section."²⁹ In his speech, on 27 May 1981, introducing s.260's successor the Treasurer stated why he thought s.260 had failed:

- (i) The language of s.260 was too wide and uncertain.
- (ii) It did not permit the purposes of the persons entering into an arrangement to be enquired into.
- (iii) It did not provide a power or procedure, once an arrangement was struck down, to reconstruct a taxable situation.³⁰

4.5.2 Part IVA

Section 260's replacement, Part IVA, encompasses sections 177A-G, which in broad terms, apply if there is "a scheme" which produces a "tax benefit" and it could be concluded, having regard to eight specified matters, that the purpose of the scheme was to obtain the "tax benefit". In those circumstances in which the provisions apply the Commissioner is required to make such adjustments as are necessary to cancel the tax benefits sought. As yet there have not been any Court cases involving Part IVA notwithstanding the Treasurer's warning that the Government

intends to rely heavily on it:

That the Government intended to rely heavily on new Pt. IVA to strike down tax schemes as they emerge 'but not to the exclusion of taking ad hoc action if we think it is necessary'. Mr. Howard went on to say -

It is my understanding that the broad approach would be - fairly early in the piece - to see the effectiveness of Part IVA tested. If a particular scheme were discovered and it was thought likely that that was struck down by Part IVA, then Part IVA would be used against that scheme. But if it transpired that it were not effective, then obviously the Government would have to give consideration to ad hoc action. But we did not spend 2½ years and obtain a lot of advice to draft a new anti-avoidance section not to try its effectiveness. We believe that it will be effective in respect of the sort of artificial schemes that we have seen over the past few years and it will be invoked against those schemes. Obviously, if it is not held by the courts to be effective, we will have to look to ad hoc action. ³¹

To assess whether the section might be effective two investigations could be made. First, the terms of the legislation itself could be analysed to see whether there are any apparent defects and secondly, the opinion of tax agents could be sought to see whether they think the legislation will have its intended effect. Hereunder are the results of the first such investigation. The results of the second investigation are given in Chapter Six (6.5).

4.5.3 The Terms of Part IVA

(a) Meaning of the Word "Scheme"

Section 177A defines a "scheme" as:

"(a) any agreement, arrangement, understanding, promise or undertaking, whether express or implied, and whether or not enforceable or intended to be enforceable, by legal proceedings, and

(b) any scheme, plan, proposal, action, course of action or course of conduct" and shall include any "unilateral scheme, plan, proposal, action, course of action or course of conduct".

Post 27 May 1981 commentary on Part IVA does not suggest any basic

weakness with this definition. It seems to be sufficiently wide to catch almost anything a taxpayer does. Given the history of the previous anti-avoidance provision (s.260) it also seems unlikely that any significant problems will arise with this definition. The equivalent in s.260 was the phrase "any contract, agreement or arrangement" and that did not create any real difficulties. Reference to s.177A(a) shows that these words are reproduced in Part IVA as the opening words of the definition of a "scheme". The definition is then expanded to cover other matters including unilateral actions taken by the taxpayer as well as transactions with others.

(b) Meaning of the Term "Tax Benefit"

Section 177C provides that there will be a "tax benefit" where:

- (a) an amount is not included in a taxpayer's assessable income, and/or
- (b) a deduction is allowed from the taxpayer's income, where that amount or deduction would be, or might reasonably be expected to be, included in or disallowed from his assessable income if the scheme had not been entered into or carried out.

Two qualifications exist regarding this definition. Firstly, s.177C(2) provides that where the tax benefit arises from a scheme involving "the making of a declaration, election or selection, the giving of a notice or the exercise of an option, expressly provided for by the Act, the scheme will fall outside the ambit of Part IV A". Secondly, s.177E(1) extends the meaning of the term "tax benefit" to include a dividend stripping operation or a scheme having substantially the effect of a dividend stripping operation. These qualifications aside, the primary definition of a "tax benefit" is likely to give rise to problems if only because of the vague way in which it is framed. The

use of the words "might reasonably be expected" pose hypothetical questions which must involve some degree of uncertainty.

Another defect in the definition of "tax benefit" is that it does not extend to tax avoidance schemes resulting from exploitation of provisions relating to rebates, credits, averaging of income, public company status, exempt income or withholding tax. This defect has been seized upon already by some taxpayers as evidenced by further anti-avoidance legislation introduced, effective from 9 February 1982, to prevent tax avoidance schemes involving rebates for calls on shares in afforestation companies and rebates for monies paid on shares in petroleum exploration companies.

(c) Matters to Which Regard must be Paid

Section 177D provides that there are eight matters to which regard must be paid before any conclusions are drawn about the "scheme" in question. These matters are:

- (i) the manner in which the scheme was entered into or carried out;
- (ii) the form and substance of the scheme;
- (iii) the time at which the scheme was entered into and the length of the period during which the scheme was carried out;
- (iv) the result in relation to the operation of this Act that, but for this Part, would be achieved by the scheme;
- (v) any change in the financial position of the relevant taxpayer that has resulted, will result, or may reasonably be expected to result, from the scheme;
- (vi) any change in the financial position of any person who has, or has had, any connection (whether of a business, family or other nature) with the relevant taxpayer,

being a change that has resulted, will result, or may reasonably be expected to result, from the scheme;

- (vii) any other consequence for the relevant taxpayer, or for any person referred to in sub-paragraph (vi), of the scheme having been entered into or carried out; and
- (viii) the nature of any connection (whether of a business, family or other nature) between the relevant taxpayer and any person referred to in sub-paragraph (vi).

Where, having regard to these eight matters, it would be concluded that the taxpayer or any other person who entered into or carried out the scheme or any part of it did so for *the sole and dominant purpose* of enabling the taxpayer to obtain the tax benefit, then Part IVA applies. Though the conclusion required by s.177D will be based on the facts in each particular case there is no indication in s.177D, or elsewhere in Part IVA, as to which of the eight matters ought to be decisive. Nor is there any indication of the weight to be attached to each matter.

According to a Second Commissioner of Taxation:

- Regard must be had to all - not just to number (iv) - the tax consequence criterion.
- *The matters listed are of varying kinds, and obviously do not have equal weight* - you can't for example, because there are eight of them, attach a 12½ per cent mark to each.
- *Matters (i) to (iii), manner, form and substance and timing are important - form and substance is very important - but are in the nature of items that help to set the scene, to provide the atmosphere of the thing, to get into realities.*
- *The next three - matters (iv) to (vi) - involve money questions - the tax saving for the taxpayer, how much he or she is otherwise in pocket or out of pocket, and the same for connected persons.*
- *In other words, (iv) to (vi) direct attention to the tax and non-tax economic realities of the scheme in question and, I think it fair to say, call for a contrast between them.*
- *Matter number (vii) calls attention to those consequences of the scheme for the taxpayer and connected persons that do not simply involve a change in tax and other financial circumstances. For*

example, the fact that a scheme has protected a person's assets from creditors or from a wife with whom he is in dispute would help to explain a transfer of assets. It would usually operate in the person's favour.

- Finally, item (viii) directs that all these things be viewed in the light of the nature of the connections - business, family or other - of the taxpayer and the persons whose financial position is changed as a consequence of the scheme. For example, in a family arrangement one has to look at things in the context of 'family'.³²

Another difficulty with s.177D was outlined by Frankel QC, who queried the use of the words "... it would be concluded ...". He asked *who* is to have regard to the eight matters specified in s.177D and *who* is to do the concluding. Is it the Commissioner, the Courts or perhaps a "reasonable man". Frankel believed this could lead to protracted argument and litigation and that this could be Part IVA's fatal flaw.³³

(d) *Purpose of Obtaining a "Tax Benefit"*

Once the eight matters are considered, Part IVA will apply if *it would be concluded* that *the purpose* of the scheme was to obtain a tax benefit. Traditionally sections enquiring into taxpayers' purposes, for example s.26(a), have resulted in a great deal of litigation. While the Courts have looked at taxpayers' actions to determine their purposes rather than their words there have been results which are hard to understand. If similar problems are to be experienced with Part IVA then the use of the word "purpose" might, later, be seen to have been unfortunate.

One other factor which will make a taxpayer's task a little more difficult in contesting Part IVA applications is the use of the word "concluded" in the phrase "it would be concluded". In the normal course of events the Commissioner will make assessments under Part IVA and then, following s.190(b), the taxpayer will have to show that *it would not be concluded*. The burden of proof on the taxpayer is, therefore, heavier than would otherwise be the case.

4.5.4 Anti-Avoidance Provisions and International Transactions

Section 136 of the 1936 Income Tax Assessment Act, and equivalent sections in previous Acts, have attempted to prevent tax avoidance where Australian businesses have been controlled by non-residents. Specifically where such a business was carried on and produced either no taxable income or less than the amount which, it appeared to the Commissioner, might have been expected to be produced, then the Commissioner was authorised to determine the taxable income and the tax payable thereon. *Prima facie*, the section ought to have been a powerful one but it, like s.260, proved to be defective. The defects became patently obvious in 1980, following the decision in *FCT v Commonwealth Aluminium Corp. Ltd.*³⁴ though the Asprey Committee had documented a number of defects five years earlier.³⁵ The defects included the fact that s.136

- (i) did not apply to taxpayers who were Australian residents;
- (ii) did not apply to non-resident taxpayers other than companies;
- (iii) applied only to non-resident companies whose day to day operations were controlled by non-residents;
- (iv) applied only to income from a business (i.e. it did not apply to interest or dividend income); and
- (v) it did not apply unless some income was derived, e.g. it did not apply to interest free loans.

To overcome these, and other defects a new division, Division 13, was introduced with effect from 27 May 1981. This, coincidentally, is the same date as Part IVA became effective. Division 13 is similar in many respects to Part IVA, although the former is confined to *international agreements*. However, unlike Part IVA the legislation to give effect to Division 13 was not introduced into Parliament until 24 March 1982.

Section 136AD is the operative section of the new division and it authorises the Commissioner to determine a taxpayer's taxable income and tax liability on the basis of arm's length consideration being paid in respect of all *international agreements*. An agreement is an *international agreement*³⁶ if:

- (a) a non-resident supplied or acquired property under an agreement otherwise than in connection with a business carried on in Australia by the non-resident at or through a permanent establishment of the non-resident in Australia; or
- (b) a resident carrying on business outside Australia supplied or acquired property under the agreement, being property supplied or acquired in connection with that business.

The main principle behind this definition is to deem an agreement an international agreement if a person has the capacity to move profits out of Australia. If such a capacity exists then Division 13 applies. But like Part IVA a case involving Division 13 is yet to come before the Courts to see whether this Division will have its intended effect.

4.5.5 Summary of the Adequacy of General Anti-Avoidance Provisions

The new anti-avoidance legislation, Part IVA, has yet to be considered by the Courts and its likely impact is therefore uncertain. In this part of the thesis an analysis of the terms of the provision suggests it does have some weaknesses despite the lengths to which the Government is reported to have gone in its drafting. Two things will impinge upon its success. Firstly, and most importantly, will be the attitude of the Courts towards the new provisions and toward tax avoidance. Secondly, will be the attitudes of the accounting and legal professions towards tax avoidance. Evidence can be gathered on both of these aspects to predict the likely effectiveness of Part IVA. Some

indication of the Courts' attitude is evident in recent decisions.

The mood of the Australian Courts, particularly the High Court, seems to have changed. When Sir Garfield Barwick was Chief Justice the approach taken in interpreting statutes was a strictly literal approach. This seemed to have paved the way for many tax avoidance schemes which exploited loopholes in particular provisions. The decisions in *Curran's Case*,³⁷ *Mullen's Case*,³⁸ *Slutzkin's Case*,³⁹ *Cridland's Case*⁴⁰ and *Westrader's Case*⁴¹ are some examples of this. The change in mood received the following editorial comment:

In the last few years there has been a marked tendency to forsake rigorous reasoning for decisions, which perhaps, accord with perceived social or moral priorities.⁴¹

Further, it was suggested that "this process is recognisable not only in the High Court but also in the Federal Court and, to a lesser degree, in some State Supreme Courts."⁴³

The recent decision of the High Court in the *Cooper Brookes' Case*⁴⁴ is typical of the present mood. In its tax return the company claimed a deduction for prior years' losses. Both the taxpayer and the Commissioner agreed that if the relevant provision, s.80C(3), was given a literal interpretation the taxpayer would be entitled to the deduction. However, in the circumstances, the Court departed from a literal interpretation to give effect to what it thought was clearly intended by the legislature.⁴⁵

This change of emphasis by the Court will be strengthened by (i) the insertion of s.15AA into the *Acts Interpretation Act* which, in effect, provides that:

in the interpretation of a provision of an Act, a construction that would promote the purpose or object

underlying the Act (whether that purpose or object is expressly stated in the Act or not) shall be preferred to a construction that would not promote that purpose or object. The section further provides that it shall not be construed as authorising the consideration of any matter or document not forming part of the Act,⁴⁶

and (ii) the new approach taken by the House of Lords in tax avoidance cases. On 12 March 1981 the House of Lords rejected two appeals over "off the peg" tax avoidance schemes. The decision in *Ramsay v CIR*⁴⁷ has been reported to be "one of the most significant Revenue cases (in the United Kingdom) since the last war".⁴⁸ Already the House of Lords decision has been referred to, with approval, by the Federal Court of Australia. In *Ilbery's Case*⁴⁹ two members of the Federal Court agreed that the principle in *Ramsay's Case*, of treating "off the hook" tax avoidance schemes, as fiscal nullities, was equally applicable in Australia as it was in the United Kingdom:

It is our opinion that what their Lordships have said is as apt for the Australian legislation as it is for that in force in the United Kingdom. It follows that if, contrary to our opinion, the expenditure was incurred in gaining or producing assessable income, the arrangement pursuant to which it was incurred should be treated as fiscally a nullity, and thus not resulting in an expenditure incurred in gaining or producing the taxpayer's assessable income.⁵⁰

Finally, some mention should also be made about other anti-avoidance legislation which the Government has introduced. Part IVA and Division 13 have not been the only legislative attacks on tax avoidance. Sections 82KH-KK and s.82KL have also been introduced to prevent particular tax avoidance schemes. These sections though they received Royal Assent on 13 March 1979 and 28 November 1979 respectively, operated from the day following their announcement dates, namely 19 April 1978 and 24 September 1978. Section 82KL has been amended since its introduction to ensure that tax avoidance schemes, similar to those originally countered, are also prevented. For instance, Act

No.19 of 1980 was introduced to deny deductions, arising out of tax avoidance arrangements, involving certain bad debts. When this Act was passed it, like similar amendments to s.82KL, was made retrospective to 24 September 1978 - the date the Treasurer first announced the provision. In those circumstances in which s.82KJ and s.82KL apply their effect is more devastating than would be the effect of Part IVA. The sections operate to deny deductions which the taxpayers had sought. The Commissioner has no power to mitigate this effect. He has such a power when Part IVA applies. Further, where either Part IV A or s.82KH-KL could apply then, pursuant to s.177B, it is the latter which operates. That is, the more potent of the two alternatives applies, but it should be stressed that the provisions of s.82KH-KL are limited to a very specialised type of tax avoidance scheme. Perhaps the most significant aspect of s.82KL is the Government's willingness to extend it to schemes not subject to previous announcements. For instance, on 4 August 1980, the Treasurer said that the following types of expenditure recoupment schemes would be affected by s.82KL (with effect, of course, from 24 September 1978):

- (i) production or marketing of films or acquisition of a copyright or licence on a film;
- (ii) operation of gold mines;
- (iii) purchase of consumable supplies; and
- (iv) carrying out of market research.

When the legislation to prevent these schemes was introduced, on 7 May 1981, it covered these four schemes *and five others* which were not subject to the earlier announcement. These five new schemes were:

- the cost of acquiring a licence in a copyright subsisting in computer software;

- commissions paid for collecting assessable income;
- costs in growing, care and supervision of trees;
- expenditure for increasing the value of shares in a company held as trading stock; and
- expenditure for the production of a master sound recording or procuring the production of a master sound recording.

The extension of the legislation to cover these schemes shows, perhaps, the Government's resolve to stamp out tax avoidance resulting from *expenditure recoupment schemes*. The likely effectiveness of the Government's general anti-avoidance provisions, Part IVA, is, at present, still uncertain.

4.6 THE EFFICIENCY WITH WHICH LEGISLATIVE DEFECTS ARE REMEDIED

Efficiency of remedial legislation can be considered in two parts. First, the speed with which action is taken to plug loopholes and secondly, the effectiveness of that action. If judgment is to be made on the efficiency of the Australian Tax System to plug loopholes information is required about several things including the date on which tax avoidance schemes were brought to the attention of the legislature, the date remedial legislation became effective and the extent to which those schemes have been discouraged. Unfortunately information is only available on one of these, *viz.* the date remedial legislation became effective, and analysis in this part is limited accordingly. Some general observations can be made. The first concerns the administrative process by which the legislature usually becomes aware of tax avoidance schemes.

If a taxpayer is involved in a tax avoidance scheme it might be two years before the legislature acts to prevent it. Claims for

deductions resulting from such schemes made during the year ended 30 June 1982 might relate to transactions carried out as early as 1 July 1981. If lodgement of returns is delayed these claims might not come to the attention of the Tax Office until March 1983. Further time might elapse before assessments are made and/or the Treasurer is informed. Delays might then occur before he announces remedial legislation. In all up to two years can elapse from the date of the original transactions.⁵¹ This is unsatisfactory and can result in avoidance by others. The delays in legislating against "Curran Schemes"⁵² is a particularly pertinent example. Newspaper reports estimate the revenue lost from this scheme was between A\$400 million and A\$1,000 million. The scheme was carried out in the 1968-69 tax year yet remedial legislation was not effective until 16 August 1977. Transcripts of the Court's decision were available in 1974. The only more blatant instance of legislative neglect was the failure, until 1981, to repeal s.260. The deficiencies of this section have received comment earlier in this chapter. The Courts brought the inadequacies of s.260 to the Government's attention as early as 1957 when Justice Kitto said:

Section 260 is a difficult provision, inherited from earlier legislation, and long overdue for reform by someone who will take the trouble to analyse his ideas and define his intentions with precision before putting pen to paper.⁵³

Following the 1982 Commonwealth Budget the Treasurer, in late August 1982, announced that there might be, in future, attempts to make improvements in this area. He was reported to have stated that he

intended to convene a conference with various State and Territory officials to discuss the question of tax avoidance and to examine any specific proposals from Tax or Corporate Affairs Commissioners aimed at improving tax law and tax collection and recovery.⁵⁴

Subsequently, on 27 September 1982, the Treasurer convened a meeting

in Sydney of Commonwealth, State and Territory treasurers, or their representatives. In a joint statement the treasurers are reported to have said that

... having regard to the importance of information in preventing avoidance practices, a committee of appropriate Commonwealth, State and Territory officers be asked to report by December 1st [1982 ... to recommend ...] appropriate legislative measures to maximise exchange of information ... ⁵⁵

[N.B. This meeting, therefore, seems to have failed to have achieved the Commonwealth Treasurer's expectation of coming up with joint legislative proposals to prevent loss of tax revenue.]

4.7 SUMMARY

The purpose of this chapter was to determine the extent to which the Australian Tax System provides taxpayers with the opportunity to avoid income tax. A review of the literature suggested that this could be done by evaluating tax avoidance opportunities in five main areas. Each of these areas was, in turn, considered and it was found that:

(a) Non-wage and salary earners seem to have considerable scope for avoidance of tax by splitting income. Business income can be split through companies, partnerships, trusts and excessive payments for goods supplied or services rendered. Property income can be split by gifts of capital or deeds of assignment. Taxpayers are not limited to any one means nor are they limited to the means outlined. Whether or not these means of splitting income were ever intended by the legislature to be available is difficult to determine. Certainly the Asprey Committee viewed many of them with disapproval, particularly because they were not available to all taxpayers. In particular, wage and salary earners or sole traders are disadvantaged. Table 4.6 compares the tax burdens

assuming four different business structures and three different income levels.

TABLE 4.6

Tax Payable under Alternative Business Structures
1982-83

	<i>Business Income \$20,000</i>		<i>Business Income \$50,000</i>		<i>Business Income \$100,000</i>	
	<i>Tax Payable</i>	<i>% Tax Pay- able by an Individual</i>	<i>Tax Payable</i>	<i>% Tax Pay- able by an Individual</i>	<i>Tax Payable</i>	<i>% Tax Pay- able by an Individual</i>
Sole Trader	\$3,954	100%	\$19,744	100%	\$49,744	100%
Company	4,164	105	15,432	78	39,424	79
Partnership	3,397	86	14,434	73	41,413	83
Trust	2,440	62	12,999	66	37,433	75

In almost all instances the sole trader pays the greatest amount of tax and tax is avoided if one of the other three structures is adopted. The exception is at the lowest income level where, under the assumptions adopted, more tax is payable if a company structure is used. This can be avoided if salary levels are increased (e.g. to \$15,000 and \$5,000 respectively).

Except, perhaps, for some professional practices there is nothing preventing most family businesses from being carried on by trustees, partnerships or companies. However, tax avoidance through income splitting is not available to persons who derive income by way of wages or salary. Such persons are taxed in the same way as sole traders but unlike sole traders do not have the opportunity to elect an alternative business structure. This inequity was recognised by the Asprey Committee which recommended various changes to restore equity. In particular the Committee was opposed to those situations in which a person split income but still had power to control the disposition of it.

(b) A number of means are still available for taxpayers to convert potential income receipts into capital. The process is not strictly one of conversion of income into capital but of taking steps to ensure that an amount, when received, is capital not income. Whatever steps have to be taken must be taken before the amounts are due to be received. Where property is disposed of opportunity exists to avoid tax. This may involve switching ownership of that property from one family member to another. If the property is a natural resource, potential income receipts can be converted into capital by ensuring that the agreement provides for payment for loss of a capital asset rather than payment per unit of the natural resource. Shareholders and retiring employees also have the opportunity to avoid tax if they defer receipt of particular payments until after the company has been dissolved or until after retirement, as the case may be. Legislation has been introduced to prevent some schemes but until capital gains are brought within the tax base there will always be scope for avoidance of tax by converting income into capital. The absence of a tax on capital gain must, in part, be responsible for providing the opportunity for at least some of the tax avoidance in this area.

(c) There are a number of exemptions from the tax base which provide scope for avoidance of tax. Some of those discussed in this chapter emanate partly from lack of provisions in the Act and partly from defects in enacted provisions. The Act fails to tax all ex-Australian income, certain fringe benefits and prizes. Gifts and proceeds from casual sales do not attract tax at all. Where tax cannot be avoided it can, in some cases, be deferred, and given the time value of money this also results in a loss of real resources for the Government. Not all exemptions from the tax base have been discussed in this chapter. Those which represent

deliberate policy have been excluded, e.g. dependent rebates (s.159J,K,L), concessional rebates (s.159N), zone allowances (s.79A) and living away-from-home allowances (s.51A). Schemes exploiting these provisions are generally evasion rather than avoidance. Some writers have argued that the above exemptions narrow the tax base and can lead to secondary evasion, i.e. taxpayers who are not entitled to the concessions may consider themselves to be treated unfairly because others are entitled to the benefits. Consequently, they adjust their tax burdens by evading tax so as to restore the perceived inequity.

(d) The anti-avoidance provisions have not been effective in preventing tax avoidance. In particular, s.260 did not prevent blatant, artificial or contrived schemes which exploited loopholes in other provisions of the Act. The section has only recently been replaced, by Part IVA and this new section is yet to be considered by the Courts. The Government has expressed its resolve to apply this new provision at an early date and to take follow up action if it is necessary. Whether the new provision will be effective will depend, to a large extent, on the approach of the Courts. Present indications are that Part IVA will be given wider application than its predecessor but only time will tell.

(e) Insufficient information is available to determine how efficiently the Australian tax system plugs up loopholes in the Act. What evidence is available does *not* support the view that it is efficient. For instance, the legislature was extremely slow in replacing s.260 and was slow in introducing legislation to prevent "Curran Schemes".

Thus, it appears that the Australian tax system has provided considerable opportunity for tax avoidance. This opportunity has not been equally available to all taxpayers with wage and salary earners having had least opportunity. The new anti-avoidance legislation should reduce the scope for blatant, artificial and contrived schemes of tax avoidance. However, while the rate scale remains steeply progressive, while capital gains go untaxed, while there are exemptions to the tax base and while tax laws are unnecessarily complex, there will always be scope for *some* taxpayers to avoid tax.

FOOTNOTES TO CHAPTER FOUR

1. *The Report of the Commonwealth Committee on Taxation*, Canberra: Australian Government Printer, June 1961. Commonly referred to as the Ligertwood Committee Report, see Chapter 21.
2. *Asprey Committee*, *op. cit.*, para. 11.29.
3. Income distributions which produce these figures are:

<i>Income Level</i>	<i>X</i>	<i>Spouse</i>	<i>Child 1</i>	<i>Child 2</i>	<i>Child 3</i>
\$ 20,000	\$8,440	\$ 8,440	\$1,040	\$1,040	\$1,040
50,000	23,440	23,440	1,040	1,040	1,040
100,000	35,788	35,788	9,474	9,475	9,475
4. *FCT v Phillips* (1977) 7 ATR 345.
5. *61st Report of the Commissioner of Taxation*, Canberra: Commonwealth Government Printer, October 1982, at p.12.
6. *Asprey Committee*, *op. cit.*, para. 11.33.
7. *Ibid*, para. 11.34.
8. *Ibid*, para. 11.39.
9. For instance, see *McIntosh v FCT* 78 ATC 4324.
10. *N.F. Williams v FCT* 72 ATC 4190.
11. *Stanton v FCT* (1955) ALR 912.
12. *Gibb v FCT* (1966) 118 CLR 628.
13. *McLaurin v FCT* (1961) 8 AITR 180.
14. *Burmah Steamship Company Ltd v IRC* (1930) 16 TC 67.
15. *Reseck v FCT* (1975) 5 ATR 538.
16. *FCT v French* (1957) 98 CLR 398.
17. Section 23(q) does not apply where s.12 of the *International Agreements Act* applies to income subject to withholding tax.
18. *FCT v Mitchum* (1965) 9 AITR 559.
19. *Scott v FCT* (1967) ALR 561.
20. *Hayes v FCT* (1956) 6 AITR 248.
21. *Ibid*, p.256.
22. *Henderson v FCT* (1970) 1 ATR 596.
23. *FCT v Copleson* 81 ATC 4550.

24. *The Australian Accountant*, August 1980, p.473.
25. See s.36A(8)-(12).
26. Baxt, R. *et al*, *Cases and Materials on Taxation*, Sydney: Butterworths, 1978.
27. *Newton v FCT* (1958) 98 CLR 1.
28. *Ibid*, pp.7-8.
29. *Australian Federal Tax Reporter* No.339, 8 June 1979, p.3.
30. The Hon. J. Howard, *Income Tax Laws Amendment Bill No.2 1981*, Second Reading Speech, 27 May 1981 at p.5.
31. *Australian Federal Tax Reporter* No.437, 1981 at p.4.
32. *Australian Income Tax Weekly Summary* No.33, 7 August 1981, pp.3-4.
33. I. Frankel quoted in *Financial Review*, 1 June 1981 at p.1.
34. *FCT v Commonwealth Aluminium Corp. Ltd* (1980) 11 ATR 42.
35. *Asprey Committee, op. cit.*, at paras 17.81 - 17.90.
36. See Section 136AC.
37. *Curran v FCT* 74 ATC 4296.
38. *Mullens v FCT* 81 ATC 4643.
39. *Slutzkin v FCT* 77 ATC 4076.
40. *Cridland v FCT* 78 ATC 4538.
41. *Westraders Pty Ltd v FCT* 80 ATC 4357.
42. *Australian Tax Planning Report* 1981 No.2 at p.12 - CCH Australia Ltd. Editorial Comment by T. Slater.
43. *Ibid*, p.12.
44. *Cooper Brookes (Wollongong) Pty Ltd v FCT* 81 ATC 4292.
45. *Ibid*, p.4292.
46. *CCH 1982 Australian Master Tax Guide*, Sydney: CCH, 1982, p.90.
47. *Ramsay v CIR* (1981) 2 WLR 449.
48. *The Guardian*, 13 March 1981.
49. *Ilbery v FCT* 81 ATC 4661.
50. *Ibid*, p.4663.

51. Delays may not be of this length if the Treasurer obtains information about tax avoidance schemes in other ways.
52. See *Curran v FCT*, *op. cit.*
53. *Newton v FCT* (1957) 97 CLR 578 at p.596.
54. *Australian Federal Tax Reporter*, CCH 1982 No.469, p.4.
55. *Financial Review*, 28 September 1982, pp.5 and 8.

CHAPTER FIVE

A SURVEY ON TAX EVASION

5.1 SURVEY OBJECTIVES

Tax evasion occurs not simply because some taxpayers have the *opportunity* to evade tax. It requires a desire or motivation on the part of the taxpayer to evade as well as the opportunity to do so. Research into evasion has often tended to confuse these two influences. An evaluation of the Australian tax system considering how it contributes to evasion by providing opportunities for would-be evaders was made in Chapter Three. Here it is proposed to outline a way of determining factors which might motivate Australian taxpayers to evade tax by *omitting income*.¹ To achieve this purpose it is necessary to obtain information from those taxpayers themselves. Unfortunately, survey research elsewhere on tax evasion has met with very low response rates because of the sensitivity of the topic. In this study it is proposed to obtain information from two different populations: first, a sample of taxpayers from the general population; second, a sample of *convicted* evaders. The same questionnaire will be distributed to samples from both populations and the replies will be analysed and compared so that various hypotheses concerning taxpayers' motivations for evading tax can be tested. An attempt will also be made to see whether various background characteristics of evaders and non-evaders can be distinguished.

Traditional methodology will also be applied to the responses received from the general population. This will enable the hypotheses to be tested a second time and will enable the methodologies to be compared. The hypotheses to be tested are those set out in Chapter Two,

Table 2.3. For convenience that table is summarised in Table 5.1.

TABLE 5.1

Possible Causes of Tax Evasion

<i>Hypothesis</i>	<i>Symptom</i>
(a) Exchange Relationship	(i) Perceptions that tax rates are too high. (ii) Perceptions that the tax system is unfair. (iii) Perceptions that the Government spends taxpayers' money unwisely.
(b) Social Orientation	(i) Basic predisposition away from the State and the law in general. (ii) Influence of groups on individual behaviour, particularly the number of evaders known by a taxpayer.
(c) Administrative Control	(i) Tax administration too coercive, e.g. tax enforcement too oppressive or too obvious. (ii) Tax administration perceived to be ineffective.

The questionnaire was also used to determine taxpayers' attitudes to some related issues as well as to determine four background characteristics of respondents. As with many surveys free space was provided to allow respondents to express their views on matters pertaining to the survey. Given in Table 5.2 are the question numbers and the reason(s) each question was asked.

5.2 RESEARCH METHODOLOGY

5.2.1 Sample Size

From the outset it was evident that the only possible means of conducting a nationwide survey was by way of mail questionnaire. The geography of Australia was only one of the potential problems faced.

TABLE 5.2

Purpose of Each Question in Tax Evasion
Questionnaire

<i>Question(s)</i>	<i>Purpose(s)</i>
1(a)-(b) 2(a)-(b)	To test the "exchange relationship" hypothesis.
2(c)-(d) 6(a)-(c)	To test the "social orientation" hypothesis.
4(a)-(c)	To test the "administrative control" hypothesis..
3	To determine respondents' attitudes to small scale and large scale evasions.
5 and 8	To determine respondents' knowledge about aspects of the tax system, in particular penalties for evasion and rates of tax.
7	To determine respondents' "tax ethic" for small scale and large scale evasions and to compare it with their ethic for another property crime.
9	To determine respondents' orientation to commit small scale and large scale evasions of tax.
10	To determine respondents' perceptions of their chances of successfully evading tax on small and large amounts of income.
11	To determine background characteristics of respondents.

A shortage of time, limited research funds and lack of research assistance prevented other forms of data gathering, especially personal interviewing, from being undertaken. The amount of funds available² also limited the size of the mail questionnaire.

A sample of 500 from the general population was used and this sample was the maximum size possible given available resources. However the use of Chebyshev-type inequalities indicated that a sample of this size was likely to provide reasonable estimates of the population proportions. Technical assistance was solicited in using the Camp-Meidell

Inequality to show that the probability of the actual sample proportion being more than 2.5% removed from the population proportion was *at most* 0.3555.³ To reduce the probability to 0.05 would have required a sample size of 3554 - seven times greater than that which could be funded.

When it is remembered that the sample from the general population was to be matched by a sample, of equal size, from the population of convicted evaders, it meant that the survey would have required a mailing of over seven thousand questionnaires, seven thousand advance letters and several thousand follow up letters, a task far beyond the resources of this researcher.

5.2.2 Survey Population

One of the methodological problems encountered in carrying out surveys is deciding from whom to collect the information; i.e. deciding upon or defining the population. Moser and Kalton suggest that in doing so "it is useful to distinguish between the population for which the results are required, the *target population*, and the population actually covered, the *survey population*".⁴ They also suggest that "ideally the two will be the same, but for practical reasons there will usually be some differences between them."⁵ This survey was no exception and it was soon apparent that the survey population and target population differed.

What would have been desirable would have been target populations comprising:

- (i) all taxpayers who, at the time of responding, evaded tax;
and
- (ii) all taxpayers who, at that same time, did not evade tax.

However, for various reasons given hereunder, the sample populations comprised:

- (a) taxpayers who had been *convicted* for evading tax *and* whose names appeared, as a result thereof, in Schedule 1 of the *60th Report of the Commissioner of Taxation 1980-81*; and
- (b) persons whose names appeared on the Commonwealth Electoral Rolls at 30 November, 1981.

Other attempts to construct population frames failed. Both the Commissioner of Taxation and the Australian Bureau of Statistics were asked to provide information for this purpose but both declined to do so. The latter, by letter dated 5 June 1981, advised that they did not have the requested information. The former, by letter dated 30 September 1980, advised that the secrecy provisions of the *Income Tax Assessment Act 1936* precluded the disclosure of the information sought.⁶ It was hoped that the Commissioner of Taxation would provide a fuller sample of evaders as well as a sample of taxpayers other than evaders. Alternatively, it was hoped that the Australian Bureau of Statistics would provide a random sample of taxpayers from the general population.

The target populations and the survey populations differed in at least two important respects. First, the survey population of "evaders" was one of *some* of the evaders who *had* evaded tax. This was inevitable because the only available list of names of evaders was that in Schedule 1 of the Annual Report of the Commissioner of Taxation and this list comprised the names of only some of the evaders. A taxpayer's name appeared in this list only where:

- (i) the taxpayer had understated the taxable income;
- (ii) the taxpayer did not voluntarily make a full and true disclosure of the understated taxable income;
- (iii) the amount of additional tax under s.226(2) exceeded \$1,250 and the total additional tax was more than 25 per cent of the increased tax resulting from the investigation; and
- (iv) the case had reached finality in the sense that the taxpayer had exhausted all rights of objection and appeal.

The list of names, therefore, did *not* include all taxpayers charged additional tax under s.226(2), nor did it include taxpayers who had been charged additional tax under other sections of the Act. In fact, as Table 5.3 shows, the list contained less than 1% of the names of taxpayers who had been charged additional tax.

TABLE 5.3

Imposition of Additional Tax for Various Evasions of
Income Tax for the Period 1 July, 1979 to 30 June, 1980

<i>Section of Act</i>	<i>Number of Taxpayers</i>	<i>Additional Tax Charged \$m</i>
s.226 (1)	125,637	17.23
s.226 (2)	42,718	69.00
s.223	34,117	2.08
s.227, 230 & 231	442	0.20
Other	<u>13,493</u>	<u>1.95</u>
(a) Total Number Charged	216,407 =====	\$90.47m =====
Number of taxpayers whose names appeared in the list		
		1,557
Less Corporate taxpayers, and	77	
Deceased individuals	<u>27</u>	<u>104</u>
(b) Maximum survey population		1,453 =====
[N.B. $\frac{b}{a} \times \frac{100}{1} = \frac{1453}{216407} \times \frac{100}{1} = 0.67\%$]		

Though the list of names contained less than one percent of taxpayers who were charged additional tax it contained the names of evaders who

- (i) were charged under the most important section imposing penalties. In fact, according to Table 5.3, over 75% of all additional tax charged was charged under s.226(2); and
 - (ii) were charged, on average, more tax than other taxpayers were charged. Under s.226(2) the average of additional tax charged for taxpayers whose names appeared in Schedule 1 was approx. \$4,000* each whereas the average, from Table 5.3, was approx. \$1,600** each.
- [* \$6,335,989 ÷ 1557 ** \$90,463,786 ÷ 216,407]

The second major difficulty with the survey population was that it contained only the names of taxpayers who *had* evaded tax *and* who had been caught and penalised for doing so. Such taxpayers once detected and penalised might no longer evade tax. Alternatively, they might continue to evade as some research suggests, especially where the underlying reasons remain or where the audit experience was unpleasant.

The target and survey populations for the general population also differed. Ideally one would have liked to draw a random sample from a general population of taxpayers who were not tax evaders. However, it was only possible to draw a random sample of persons whose names appeared on the Commonwealth Electoral Rolls. Although a person was not eligible to be enrolled if he had been convicted of certain offences tax evasion was not one of them. The electoral rolls could, therefore, have contained the names of both evaders and non-evaders. Table 5.4 shows the total number of persons enrolled at 30 November 1981.

TABLE 5.4

Number of Persons whose Names appear on the
Commonwealth of Australia's Electoral Rolls,
as at 30 November, 1981

<i>State/Territory</i>	<i>Number</i>	<i>%</i>
A.C.T.	135,965	1.47
N.S.W.	3,258,560	35.27
N.T.	55,443	0.60
QLD.	1,391,155	15.06
S.A.	851,521	9.22
TAS.	269,050	2.91
VIC.	2,498,595	27.05
W.A.	<u>777,935</u>	<u>8.42</u>
	9,238,224	100.00
	=====	=====

[Source: Commonwealth Electoral Rolls]

Another difficulty with the Commonwealth Electoral Rolls was that they could not have been used to produce a strictly random sample because rolls for individual electorates were made up at different dates.⁷ Thus it was possible for the names of individuals who moved from one State to another, to have appeared on two rolls. However, it was considered that the divergences were likely to have been slight.

5.2.3 Pilot Survey

Survey questions were pretested with a pilot survey conducted in March/April 1981. Limited resources restricted the pilot survey sample in two ways: first, the sample size was limited to one hundred and second, the population frame was confined to New South Wales residents. As with the full scale survey, this survey was divided into two populations but the size of each was only fifty; i.e. fifty "evaders" and fifty "non-evaders". An eight page mail questionnaire was sent to a random sample from each group. Each group was further subdivided into two subgroups of equal size to test whether the response rate was influenced by offering only one of the subgroup an incentive to reply. The chosen incentive was a biro and because the survey dealt with the "black economy" it was considered that the appropriate colour of the biro should be black! Of the one hundred questionnaires which were mailed eight were returned unopened leaving an effective mailing of ninety-two; from these, thirty-five responses were received as shown in Table 5.5.

TABLE 5.5

Number of Responses to the Pilot Survey on
Tax Evasion

	<i>Incentive</i>	<i>No Incentive</i>	<i>Total</i>
"Evaders"	9	7	16
"Non-Evaders"	<u>14</u>	<u>5</u>	<u>19</u>
	23	12	35
	==	==	==

A chi-square test on the responses revealed no statistical difference between the two groups, i.e. between the number of responses from evaders and non-evaders. When the chi-square test was repeated to determine the influence of the incentive on responses it was found that the incentive made no difference to responses from "evaders" ($\chi^2 = 0.25$) but did make a difference on responses from "non-evaders" ($\chi^2 = 4.26$; with $\chi^2_{0.05} = 3.84151$, $df = 1$). The relatively low response rate (38%) was worrying and ways of improving it, for the full scale survey, were sought. In planning for the full scale survey it was decided to:

- (i) draw samples of equal sizes from the two survey populations;
- (ii) persist with the idea of offering both evaders and non-evaders a black biro as an incentive to reply even though it only made a significant difference in responses from non-evaders;
- (iii) shorten the questionnaire by omitting some questions not directly related to the-main hypotheses;
- (iv) have the final questionnaire typed on foolscap sized paper and then have it photo-reduced to A4 size, to make it appear smaller; and
- (v) personalise all communications with respondents. In fact Erodo and Morgan⁸ argue that personalising communications is the best, and perhaps the only, way to get a high response rate. With this in mind it was decided that all letters should be *personally signed*⁹ and that the first name of each addressee be handwritten at the top of each letter.

Some changes were made to the questions asked in the pilot survey but an effort was made to limit the number of changes so that a second pilot survey was unnecessary. Changes were also made to remedy apparent defects in questions and to shorten question length.

Comments received from some of the "non-evaders" suggested the reason they did not evade tax was because they did not have the opportunity to do so. Had they had the opportunity to evade tax then they would, they said, have evaded it. This type of comment suggested that it might

be as well to include questions asking respondents to indicate their perceptions of their opportunities for evading tax and their perceptions of their chances of success if they did evade tax. The addition of these questions might then help to explain some of the differences in the incidence of evasion should the three main hypotheses fail to do so. That is, the fact that some do not evade tax might merely reflect their lack of opportunity to do so and not the absence of motivational influences.

5.3 SURVEY RESPONSES

The same questionnaire was sent to samples ($n = 500$) from both populations, namely the general population (hereinafter referred to as "non-evaders") and convicted evaders (hereinafter referred to as "evaders"). It should, perhaps, be emphasised that individuals receiving the questionnaires were *not* aware that these two groups had been generated *or* that the author knew that they necessarily belonged to one of them. All that individuals were told was that their addresses had been taken from the electoral rolls. This was in fact true. However, their names had been taken from different sources. Questionnaires were distinguished by the angle of the staple in the top left hand corner. All usable responses received within six weeks of questionnaire mailing were included in the results. Full details about responses from both groups are shown in Table 5.6.

Responses for each survey were classified by date of receipt with 'late' responses being assumed to be those received after the follow-up letters were mailed. This enabled tests to be carried out to test for non-response bias. The 'late' response category was assumed to be an

TABLE 5.6

Responses Received from the Tax Evasion Survey

	<i>Evader Group</i>	<i>Non-Evader Group</i>
Total number of questionnaires mailed	500	500
Number of questionnaires returned unopened	<u>11</u>	<u>17</u>
Effective mailings	489 =====	483 =====
Responses received	216	219
Responses not usable	<u>9</u>	<u>14</u>
Usable responses	207 =====	205 =====
Effective response rate i.e. $\frac{\text{usable responses}}{\text{effective mailings}} \times \frac{100}{1} =$	42%	42%

accurate reflection of the likely responses from those who did not reply.¹⁰ Chi-square independence tests and analysis of variance tests, as required, were used to test for non-response bias and it was found that:

- (i) on *all* thirty questions there was *no* statistically significant difference between early and late replies received from the "non-evader" group. That is, there was no non-response bias on any question for this group.
- (ii) for twenty-seven of the thirty questions there was *no* statistically significant difference between early and late replies received from the "evader" group. That is, for almost all questions, there was no non-response bias. However, there was a significant difference, at the 5% level, between 'early' and 'late' responses on three questions.¹¹ Care was taken in analysing these questions and before inferences were drawn results were recomputed to take account of the bias. Fortunately, each question was only a component part of tests to be carried out.

For instance, there was non-response bias on question 10(i) but not on 10(ii) and 10(iii) and all three parts involved the same point. They differed only in degree, *viz.* 10(i) involved \$100, 10(ii) \$1,000 and 10(iii) \$10,000. Surprisingly there was no non-response bias on questions which elicited responses on taxpayers' approval/disapproval for evasion practices. For instance, questions 3(a)-(c) asked taxpayers about their approval for small scale and large scale evasions and no difference was found in responses given by 'early' and 'late' respondents. *Overall* there was little reason to expect bias.

When the comparisons between responses from evaders (adjusted for non-response bias) and non-evaders were made the results obtained were compared with those obtained from comparisons of the unadjusted data. In only one instance was there a different result (see 5.4). Significantly, there were no differences in the results obtained on questions relating to the three main hypotheses.¹²

Compared with the pilot survey there was an improved response rate for the full scale survey. The improved response rate, an increase from 38% to 42%, was attributed to the changes made to questionnaire length and format as well as to offering the incentive to *all* persons surveyed. A copy of the questionnaire is reproduced in full in Appendix 1 together with the cell counts for each question. For simplicity the cell counts for evaders and non-evaders are given alongside one another.

5.4 POSSIBLE CAUSES OF TAX EVASION

One purpose of the survey was to determine whether there were any behavioural differences between evaders and non-evaders. According to Oppenheim¹³ behaviour has two components, *viz.* "a person's inner

determinants such as temperament, attitudes, or character traits ... and all the environmental factors as perceived by the individual."¹⁴ He further states that "an attitude scale may indicate inclinations towards cheating, but the respondent will probably act honestly if he thinks he will be found out."¹⁵

Behaviour can, therefore, be loosely regarded as a function of attitudes and opportunity. This being so it was considered important to determine whether evaders and non-evaders gave different answers in relation to questions three and ten. These two questions were included in the questionnaire to determine taxpayers' attitudes to tax evasion and, what this author will call, their *opportunity* to commit it. The answers are given in Tables 5.7 and 5.8.

Chi-square tests of significance, at the 5% level, showed a statistically significant difference of opinion on *each* of the "attitude" questions [q.3(a)-(c)] but on only *one* of the "opportunity" questions [q.10(ii)],¹⁶ suggesting, perhaps, that attitudes were more important than opportunities in determining taxpayers' behaviour. For further analysis the information contained in Tables 5.7 and 5.8 was reorganised as shown in Tables 5.9 and 5.10.

[N.B. There was evidence of non-response bias on question 10(i). Consequently the raw data were adjusted to give new estimates of the population proportions. This was done by extrapolating the late respondent profile onto the non-respondents. When this was done and the responses of evaders were compared with those of the non-evaders there was a statistically significant difference between the responses of the two groups. The first element of Table 5.8, adjusted for non-response bias, is shown in Table 5.8A.

TABLE 5.7

Taxpayers' Attitudes to Small Scale and Large
Scale Tax Evasions

Questions	Answers%	
	Evaders	Non-Evaders
3(a) How do you feel about someone, in circumstances similar to your own, who omits \$100 cash earnings from his income tax return?		
Strongly approve	13	6
Slightly approve	18	19
Indifferent	41	37
Slightly disapprove	21	23
Strongly disapprove	7	15
Total	100	100
	===	===
3(b) How do you feel about someone, in circumstances similar to your own, who omits \$1000 cash earnings from his income tax return?		
Strongly approve	8	3
Slightly approve	10	12
Indifferent	29	22
Slightly disapprove	38	32
Strongly disapprove	15	31
Total	100	100
	===	===
3(c) How do you feel about someone, in circumstances similar to your own, who omits \$10,000 cash earnings from his oncome tax return?		
Strongly approve	6	2
Slightly approve	3	3
Indifferent	20	14
Slightly disapprove	28	22
Strongly disapprove	43	59
Total	100	100
	===	===

TABLE 5.8

Taxpayers' Opportunities to Commit Small Scale
and Large Scale Tax Evasion

Questions	Answers %	
	Evaders	Non-Evaders
10(i) Some people find it easy to successfully hide income from the tax man whereas others find it hard. What chance would someone like yourself have of successfully hiding \$100?		
A very good chance	35	37
A good chance	13	20
I have no idea	13	10
A poor chance	15	15
A very poor chance	<u>24</u>	<u>18</u>
Total	100	100
	===	===
10(ii) Some people find it easy to successfully hide income from the tax man whereas others find it hard. What chance would someone like yourself have of successfully hiding \$1,000?		
A very good chance	8	7
A good chance	14	14
I have no idea	6	17
A poor chance	27	24
A very poor chance	<u>45</u>	<u>38</u>
Total	100	100
	===	===
10(iii) Some people find it easy to successfully hide income from the tax man whereas others find it hard. What chance would someone like yourself have of successfully hiding \$10,000?		
A very good chance	2	1
A good chance	5	1
I have no idea	6	9
A poor chance	10	13
A very poor chance	<u>77</u>	<u>76</u>
Total	100	100
	===	===

TABLE 5.8A

Taxpayers' Opportunities to Commit Small Scale
and Large Scale Tax Evasion (Adjusted for non-
response bias)

<i>Questions</i>	<i>Answers %</i>	
	<i>Evaders</i>	<i>Non-Evaders</i>
10(i) Some people find it easy to successfully hide income from the tax man whereas others find it hard. What chance would someone like yourself have of successfully hiding \$100?		
A very good chance	30	37
A good chance	9	20
I have no idea	16	10
A poor chance	21	15
A very poor chance	<u>24</u>	<u>18</u>
Total	100	100
	===	===

This recast result does not alter the finding in Table 5.8 that non-evaders thought that they, on average, had a better chance to hide income of \$100. It merely increases the gap between the two groups (from 9% to 18% - see Table 5.10).]

TABLE 5.9

Percentage of Taxpayers who "Disapproved"
of Tax Evasion

	<i>Evaders</i>	<i>Non-Evaders</i>
Omitting Earnings of		
\$ 100	28%	38%
1,000	53	63
10,000	71	81

TABLE 5.10

Percentage of Taxpayers who had the Opportunity
to Evade Tax

	<i>Evaders</i>	<i>Non-Evaders</i>
Opportunity to Omit Cash		
Earnings of \$ 100	48%*	57%
1,000	22	21
10,000	7	2

*[This became 39% after adjusting for non-response bias.]

Table 5.9 shows that for very small evasions, *viz.* omitting \$100 cash earnings, there was very little disapproval from either group. Only 28% from the evader group and 38% from the non-evader group disapproved of this action. Table 5.9 also shows two trends emerging: firstly, at each of the three income levels, a greater percentage of non-evaders disapproved of others omitting income from their tax returns; and secondly, as the income level increased, an increasing percentage in *both* groups disapproved of omission of income.

As expected, as income level rose perceived opportunity to evade fell. This was evident for both evaders and non-evaders. Further, a greater percentage of evaders admitted opportunity to evade tax by omitting income of \$1,000 and \$10,000. Surprisingly, however, a smaller percentage of evaders admitted opportunity to evade tax by omitting small amounts of income of say \$100. Perhaps evaders, in general, were more guarded in their admissions. But if this was so for \$100 why was it not so at the \$1,000 level and the \$10,000 level? Alternatively, having been convicted they might now see less opportunity. But again why only at this level? Another important feature of Table 5.10 is the high proportion (57%) of non-evaders who thought that they could successfully hide cash earnings of \$100 from the tax man. If Table 5.10 is a true indication of the opportunity for small scale evasions, it seems then that if taxpayers are prepared to take advantage of those opportunities small scale evasion could be widespread.

The attitudinal differences between evaders and non-evaders were also evident in answers to question 7(b) which asked how seriously different tax offences were regarded by respondents. The answers are condensed in Table 5.11.

TABLE 5.11

Percentage of Taxpayers Who Did NOT Regard
Tax Evasion as "Serious"

	<i>Evaders</i>	<i>Non-Evaders</i>
Evading tax of \$100	68%	56%
1,000	38	23
10,000	16	6

Although there was a majority in both groups (68% and 56% respectively) who *did not* regard small scale evasion *viz.* evasion of \$100 tax as serious, there was a statistically significantly greater percentage of evaders who *did not* regard tax evasion as serious. Further, as the size of the offence increased the proportion in both groups, who *did not* regard evasion as serious decreased. That is, both evaders and non-evaders regarded evasions of larger amounts as more serious than evasions of smaller amounts. However, there was no statistically significant difference between responses from evaders and non-evaders for evasions of tax at the two higher levels. Yet in both instances evaders regarded the offences less seriously than did non-evaders.

Findings about the three main hypotheses that were tested are given below. After that, in section 5.5, are findings about other attitudinal questions and then, in section 5.6, there is a summary of comments received from both groups.

5.4.1 Findings about the "Exchange Relationship" Hypothesis

The exchange relationship hypothesis was tested with questions about respondents' perceptions of the level of income tax [Questions 1(a) and 1(b)], whether they were satisfied with the way the Government spent taxpayers' money [Question 2(a)] and whether they were satisfied with income tax laws [Question 2(b)]. The questions and responses are reproduced in Table 5.12.

TABLE 5.12

Answers to Questions Relating to the Exchange
Relationship Hypothesis

Question	Answers %	
	Evaders	Non-Evaders
1(a) What do you think about the amount of income tax you pay <i>compared with</i> the amount you earn?		
Much too high	57%	47%
A little too high	32	38
About right	10	13
A little too low	1	1
Much too low	-	1
	<u> </u>	<u> </u>
Total	100	100
	===	===
1(b) What do you think about the amount of income tax you pay <i>compared with</i> the amount of Government services from which you, and any dependents you might have, personally benefit?		
Much too high	41	35
A little too high	13	22
About right	19	17
A little too low	13	17
Much too low	14	9
	<u> </u>	<u> </u>
Total	100	100
	===	===
2(a) How do you feel about the way the Government in Canberra spends your money?		
Very satisfied	2	1
Somewhat satisfied	19	17
Indifferent	7	9
Somewhat dissatisfied	41	40
Very dissatisfied	31	33
	<u> </u>	<u> </u>
Total	100	100
	===	===
2(b) How do you feel about income tax laws in this country?		
Very satisfied	1	-
Somewhat satisfied	11	16
Indifferent	6	9
Somewhat dissatisfied	37	36
Very dissatisfied	45	39
	<u> </u>	<u> </u>
Total	100	100
	===	===

The results showed that a majority of both evaders and non-evaders thought that tax rates were too high, both in relation to earnings and Government services received. In relation to earnings 89% of evaders and 85% of non-evaders thought that tax rates were too high, and in relation to Government services received 54% of evaders and 57% of non-evaders thought tax rates were too high. Consequently, chi-square tests of significance, at the 5% level of significance, revealed that there were *no* statistically significant differences of opinions between evaders and non-evaders for questions 1(a) and 1(b).¹⁷ [N.B. Because of the low cell counts in question 1(a) the cells were collapsed to form a 2 x 2 contingency table but again no statistical difference between the two groups was evident.¹⁸]

Earlier research indicated that *if* tax rates were important in influencing taxpayers' behaviour, it was taxpayers' perceptions of those rates rather than the actual rates themselves. While questions 1(a) and 1(b) sought taxpayers' perceptions of tax rates the author was curious to see whether taxpayers knew the actual tax rates. Therefore, question 8 asked: "if your annual earnings were \$20,000, and you earned one more dollar how much of that dollar do you think the law requires should go in tax?" Both groups underestimated the rate. Evaders, on average, guessed 36.3% and non-evaders guessed 36.8%. Analysis of variance test between group means showed no difference in the answers given. Table 5.13, which summarises the results, shows that only about one-third in both groups were close to the correct answer (*viz.* 46%). Chi-square tests on responses, summarised in Table 5.13, showed there was *no* statistically significant difference between the answers given by the two groups ($\chi^2 = 8.745$, $df = 4$). But Table 5.13 showed that only 37% from each group nominated the correct range (41-50%). If perceptions

TABLE 5.13

Taxpayers' Knowledge of Marginal Tax Rates

	<i>Tax Per Dollar</i>	<i>Evaders %</i>	<i>Non-Evaders %</i>
Marginal tax	Nil	12	15
Rate if earnings were	25¢ or less	19	10
\$20,000 p.a.	26¢ - 40¢	18	24
	41¢ - 50¢	37	37
	Above 50¢	<u>14</u>	<u>15</u>
		100	100
		===	===

of tax rates influence the level of evasion one wonders how much more evasion there might be if all taxpayers knew the exact rates of tax. [N.B. Notwithstanding the care taken in wording the question, it is possible that respondents gave answers about the *average* rate of tax rather than the *marginal* rate. The average rate of tax was 26.8%. Respondents' perceptions about this average rate were excessive - by some 10 percentage points - perhaps reflecting their opinion that tax rates were seen to be high.]

Table 5.12 shows that about *three-quarters of respondents in both* groups were *dissatisfied* with (i) the way the Federal Government was spending their money; and (ii) the income tax laws in Australia. Again chi-square tests on responses to both questions, 2(a) and 2(b), revealed *no* statistical difference.¹⁹ If these views reflect those of the general population then it would seem that the great bulk (almost 90%)²⁰ of Australian taxpayers think, therefore, that tax rates are too high. Also, over 70%²¹ think that the Government spends taxpayers' money unwisely and almost 80%²² are dissatisfied with our income tax laws. Because of the similarity in responses between the two groups it was difficult for the "exchange relationship" hypothesis to distinguish responses from the two groups.

5.4.2 Findings about the "Social Orientation" Hypothesis

The social orientation hypothesis was tested by questions seeking to determine respondents' basic predisposition to the State and its laws and the influence of groups on individual behaviour, particularly the number of evaders known to a respondent. The social orientation hypothesis was tested with questions 2(c)-(d) and questions 6(a)-(c). The questions and responses are given in Table 5.14.

TABLE 5.14

Answers to Questions Relating to the Social Orientation Hypothesis

Question	Answers %	
	Evaders	Non-Evaders
2(c) How do you feel about laws (other than tax laws) in this country?		
Very satisfied	8	1
Somewhat satisfied	35	36
Indifferent	14	19
Somewhat dissatisfied	32	33
Very dissatisfied	11	11
	100	100
	===	===
2(d) How do you feel about the way you have been treated in dealings with Government Departments?		
Very satisfied	8	9
Somewhat satisfied	31	30
Indifferent	17	18
Somewhat dissatisfied	21	25
Very dissatisfied	23	18
	100	100
	===	===
6 We all hear about people cheating on their income tax returns but some of us hear about it more often than others. If ten (10) people known to you were "officially investigated" by Income Tax Officers how many do you think would be discovered?	Average Number	Average Number
(a) cheating a little (say omitting less than \$100 earnings)	4.976	3.756
(b) cheating a lot (say omitting more than \$1,000 earnings)	3.995	2.673
(c) cheating a great deal (say omitting more than \$10,000 earnings)	2.870	2.449

Chi-square tests of significance were applied to responses for questions 2(c) and 2(d) and these revealed a statistically significant difference on the first question²³ but not on the second.²⁴ However, with question 2(c) there was a cell count less than five²⁵ in one space. Cells were collapsed to eliminate this low count and form a 2 x 2 contingency table. The chi-square test was then repeated, however no difference was found in the responses of the two groups.²⁶ Further, when the initial statistically significant difference was closely examined, the direction of the relationship was opposite to that expected. Prior theory suggested that *if* there was a difference then it should be non-evaders who were more satisfied with non-tax laws. This was not the case. Only 39% of non-evaders were satisfied with non-tax laws compared with 43% of evaders who were satisfied. Finally, it also seemed odd to find roughly the same percentage, about 40%, of both groups dissatisfied with non-tax laws. This bi-modal distribution was also evident for both groups for the question dealing with taxpayers' level of satisfaction in dealings with Government departments. No simple explanation offers itself. Further enquiries need to be made.

Analysis of variance tests were applied to responses for question 6 (the question dealing with the number of evaders known to respondents) and it was found that, at the 5% level of significance, there *was* a statistically significant difference between the means in two of the three cases.²⁷ It was also found that, on average, evaders in *each* of the three cases thought they knew more evaders than did non-evaders. Though the difference was not statistically significant for very large evasions (omitting >\$10,000 of cash earnings) it was statistically different for small (<\$100) and medium (>\$1,000) evasions. What was also somewhat surprising was the number of respondents from the general population, that is the "non-evader" group, who thought they knew others

who omitted income at each of the three levels. Seventy-one percent of the general population thought they knew at least one person who omitted cash earnings of \$100, 63% thought they knew of at least one person who omitted cash earnings of \$1,000 and 46% thought they knew of at least one person who omitted cash earnings of \$10,000. The respective percentages for evaders were 76%, 75% and 55%.

Evasion, particularly of small amounts, could be quite widespread, and even evasion of large amounts might also be relatively significant. For example, based on the general population's responses to question 6(c) it would seem that about 25% of people omit \$10,000 of cash earnings from their income tax returns ($\bar{x} = 2.449$) and about 40% omit at least \$100 cash earnings ($\bar{x} = 3.756$). But it should be emphasised that these estimates are based on respondents' perceptions, about others' behaviour, and may not necessarily reflect reality.

5.4.3 Findings about the "Administrative Control" Hypothesis

The administrative control hypothesis argues that tax evasion is likely to be influenced by control systems which are too weak or too oppressive. In the survey questions 4(a)-(c), in effect, asked taxpayers how satisfied they were with aspects of income tax administration and tax enforcement activities of the Tax Office. The responses are summarised in Table 5.15. Because answers from respondents who indicated that the question was not applicable are excluded, the number of responses in each column varied. These variations do not show up in Table 5.15 because the figures are shown as percentages.

Chi-square tests on three of the four questions revealed statistically significant differences at the 5% level of significance.²⁸

TABLE 5.15

Answers to Questions Relating to the Administrative
Control Hypothesis

Question	Answers %	
	Evaders	Non-Evaders
4(a)(i) How satisfied are you with the efficiency of the Income Tax Office in dealing with your annual return - for example the <i>time</i> it takes to deal with your annual return?		
Very satisfied	31	33
Somewhat satisfied	31	39
Indifferent	17	7
Somewhat dissatisfied	14	14
Very dissatisfied	<u>7</u>	<u>7</u>
Total	100	100
	===	===
4(a)(ii) How satisfied are you with the efficiency of the Income Tax Office in dealing with your annual return - for example the <i>way</i> in which the Income Tax Office deals with your annual return?		
Very satisfied	22	29
Somewhat satisfied	30	41
Indifferent	13	13
Somewhat dissatisfied	21	11
Very dissatisfied	<u>14</u>	<u>6</u>
Total	100	100
	===	===
4(b) How satisfied are you paying income tax by way of " <i>provisional tax</i> "?		
Very satisfied	6	4
Somewhat satisfied	11	9
Indifferent	8	14
Somewhat dissatisfied	14	23
Very dissatisfied	<u>61</u>	<u>50</u>
Total	100	100
	===	===
4(c) How satisfied are you with " <i>official investigations</i> " by Income Tax Officers of your tax affairs?		
Very satisfied	7	13
Somewhat satisfied	12	15
Indifferent	15	35
Somewhat dissatisfied	23	21
Very dissatisfied	<u>43</u>	<u>16</u>
Total	100	100
	===	===

Only question 4(b), the question relating to provisional tax (a method of paying tax), showed *no* statistically significant difference. Of importance was the statistically significant difference obtained on question 4(c) relating to taxpayers' level of satisfaction with Tax Office enforcement activities. A majority of evaders (66%) were dissatisfied with official investigations of their tax affairs whereas only about half that number of non-evaders (37%) were similarly dissatisfied. As a result there was a statistically significant difference²⁹ and a moderately *positive* relationship between the level of dissatisfaction with official investigation and classification as an evader.

Evaders also tended to be more dissatisfied with the *time* it took the Tax Office to process their annual returns and the *way* in which the Tax Office dealt with their annual return. Difference on both of these aspects [questions 4(a)(i) and (ii)] were statistically significant even though, in both cases, a majority of evaders were "satisfied" with Tax Office efficiency. The percentages for evaders on questions 4(a)(i) and (ii) were 62% and 52% compared with non-evaders 72% and 70% respectively.

Almost three-quarters of both evaders and non-evaders were dissatisfied with the system of provisional tax and this similarity of opinion may have accounted for the lack of statistical difference between the two groups on this question. Some 75% of evaders who paid provisional tax were dissatisfied with that method of payment and only a slightly smaller percentage (73%) of non-evaders were similarly dissatisfied.

5.5 APPLICATION OF TRADITIONAL ANALYSIS

The methodology used so far does not appear to have any precedent. The author is not aware of any other studies which have tested hypotheses by comparing answers given by convicted evaders with answers given by people from the general population. To verify the results so far obtained it was decided to retest the hypotheses with what the author will call 'traditional methodology'. Previous studies on tax evasion had taken samples from the general population and had tested various hypotheses between 'groups' generated from that sample. In essence, the groups generated have been *those suspected of evading tax* and *those not suspected of evading tax*. The criteria used to distinguish the two groups have varied. In some cases it has been respondents' attitude to evasion (with those approving of evasion being suspected evaders)³⁰ and in other cases it has been respondents' own estimates of their likelihood of committing evasions (with those indicating that they would evade being classified as evaders).³¹ Here it was decided to use *both* of these traditional approaches. The relevant questions used to classify taxpayers as "suspected evaders" and "suspected non-evaders" were questions three and nine and for convenience these questions are reproduced below.

The purpose of these questions was to solicit responses from individuals about their attitudes to tax evasion (question 3) and their orientation to commit tax evasion (question 9). Each question was divided into three parts and this allowed three tests for *each* of the 'traditional methodologies' to be carried out. In all six tests were made. Respondents were classified as 'suspected evaders' where

- (i) for question 3, they indicated that they either "strongly approved" or "approved" of the specified offence; and

Question

3. How do you feel about the following:

Someone, in similar circumstances to your own, who omits

(a) \$100 cash earnings from his income tax return

(b) \$1,000 cash earnings from his income tax return

(c) \$10,000 cash earnings from his income tax return

Strongly Approve

Approve

Indifferent

Disapprove

Strongly Disapprove

(Circle one number for each question)

1 2 3 4 5

1 2 3 4 5

1 2 3 4 5

Almost Certainly Omit It

Very Likely Omit It

Not Sure

Very Likely Include It

Almost Certainly Include It

9. When completing an income tax return, what do you think someone like yourself would do about cash earnings from a part-time job if they amounted to:

(i) \$100

(ii) \$1,000

(iii) \$10,000

(Circle one number for each question)

1 2 3 4 5

1 2 3 4 5

1 2 3 4 5

- (ii) for question 9, they indicated that they would either "almost certainly omit" or "very likely omit" the specified amount of cash earnings.

Those not being so classified fell into the other group, i.e. "suspected non-evaders". The findings relating to the three main hypotheses follow.

5.5.1 Exchange Relationship Hypothesis and the Traditional Analysis

The results of comparisons of answers from "suspected evaders" and "suspected non-evaders" on the exchange relationship hypothesis are given in Table 5.16. That table shows the chi-square values only where

TABLE 5.16

Exchange Relationship Hypothesis and the Traditional
Analysis, Significant Chi-Square* Values

	<i>Attitudes to Tax -Evasions</i>			<i>Orientations to Commit Tax Evasions</i>		
	Q.3(a)	Q.3(b)	Q.3(c)	Q.9(i)	Q.9(ii)	Q.9(iii)
Questions relating to the Exchange Control Hypothesis						
1(a)	-	-	-	-	-	-
1(b)	-	-	-	-	-	-
2(a)	-	-	-	-	-	-
2(b)	-	-	-	6.695	-	-

[*Because of low cell counts cells were collapsed and 2x2 contingency tables were used.]

significant differences were obtained. Of the twenty-four possible sources of difference *only one* statistically significant difference was found. The contingency table which produced this difference is reproduced in Table 5.17 as a 2 x 2 contingency table. However, when the data were reduced in this way, and low cell counts made it necessary to do so, a problem arose. Table 5.17 shows a majority from both groups were

TABLE 5.17

Analysis of Suspected Evaders and Non-Evaders
and Satisfaction with Income Tax Laws

		<i>Suspected Evaders</i>	<i>Suspected Non-Evaders</i>
Whether satisfied with Tax Laws	Yes	12%	27%
	No	88	73
Total		100%	100%
		====	====

dissatisfied with tax laws, however chi-square tests suggested that there was *no* statistically significant difference between the respective proportions. Further, the fact that only one of the twenty-four tests produced a significant result, at the 5% level, was of concern. This might suggest that the exchange relationship hypothesis was not important or alternatively it might suggest that the methodology was defective; for example selection criteria might not have adequately discriminated the two groups.

5.5.2 The Social Orientation Hypothesis and the Traditional Analysis

The social orientation hypothesis was tested by questions 2(c)-(d) and questions 6(a)-(c) and the results on these are given in Table 5.18. Again, although both traditional methodologies were used only two statistically significant results, at the 5% level of significance, were recorded. This time there were thirty sources of possible difference.

The data which provided the two differences are shown in Tables 5.19 and 5.20. Prior theory suggested that if there was to be difference between the two groups then there would be a smaller proportion of suspected evaders who would be satisfied with non tax laws. This in fact was the case as Table 5.19 shows. Some 23% of the "evader" group were satisfied with non tax laws whereas 44% of the "non-evader" group

TABLE 5.18Social Orientation Hypothesis and the Traditional
Analysis, Significant Chi-square* Values

Questions relating to Social Orientation Hypothesis	<i>Attitudes to Tax Evasion</i>			<i>Orientations to Commit Tax Evasions</i>		
	Q.3(a)	Q.3(b)	Q.3(c)	Q.9(i)	Q.9(ii)	Q.9(iii)
2(c)	7.030	-	-	-	-	-
2(d)	-	-	-	-	-	-
6(a)	-	-	-	-	-	-
6(b)	-	-	-	13.084	-	-
6(c)	-	-	-	-	-	-

[* For Q.6(a)-(c), 2 x 5 contingency tables were formed with the cutpoints being 2,4,6, and 8. In all other cases 2 x 2 tables were formed.]

TABLE 5.19Analysis of Suspected Evader and Non-Evader and
Satisfaction with Non-Tax Laws

		<i>Suspected Evaders</i>	<i>Suspected Non-Evaders</i>
Whether Satisfied with Non Tax Laws	Yes	23%	44%
	No	<u>77%</u>	<u>56%</u>
Total		100%	100%
		=====	=====

TABLE 5.20Analysis of Suspected Evader and Non-Evader and
Number of Persons Omitting more than \$1,000 Cash
Earnings

		<i>Suspected Evaders</i>	<i>Suspected Non-Evaders</i>
Number of Evaders Known	Two or less	59%	58%
	Three or Four	18	14
	Five or Six	15	5
	Seven or Eight	4	11
	More than Eight	<u>4</u>	<u>13</u>
		100%	100%
		=====	=====

were satisfied. When the other statistically significant difference was closely examined an anomaly arose as Table 5.20 shows.

The average number of people who "suspected evaders" thought would omit \$1,000 cash earnings from their tax returns was 2.4 whereas for "suspected non-evaders" it was 3.2. An alternative test of significance was then carried out on all of the data. The ensuing analysis of variance test revealed *no* statistically significant difference³² at the 5% level of significance. This seemed a more sensible result. Had there been a significant difference, the relationship involved would have been in a direction opposite to that prior theory would have suggested. Therefore it was decided that the result should be discarded. This meant that there was only one statistically significant difference on the questions relating to the social orientation hypothesis; one difference out of thirty possibilities!

5.5.3 The Administrative Control Hypothesis and the Traditional Analysis

Results of chi-square tests, at the 5% level of significance, on questions relating to the administrative control hypothesis are given in Table 5.21.

TABLE 5.21

Administrative Control Hypothesis and the Traditional Analysis, Significant Chi-Square Values

Questions relating to the Administrative Control Hypothesis	<i>Attitudes to Tax Evasion</i>			<i>Orientations to Commit Tax Evasions</i>		
	Q.3(a)	Q.3(b)	Q.3(c)	Q.9(i)	Q.9(ii)	Q.9(iii)
4(a)(i)	-	-	5.410	-	-	-
4(a)(ii)	9.731	7.037	17.333	-	-	-
4(b)	-	-	-	-	-	-
4(c)	-	-	-	-	-	9.855

The most striking result occurred with the first of the traditional analyses on question 4(a)(ii) - a question relating to respondents' level of satisfaction with the way the Tax Office had dealt with their annual returns. A summary of the *three* contingency tables is given in Table 5.22.

TABLE 5.22

Analysis of Suspected Evaders and Non-Evaders and
Satisfaction with the Way the Tax Office Dealt with
Annual Returns

	<i>Percent Dissatisfied with Treatment</i>	
	<i><u>Suspected</u></i>	<i><u>Suspected</u></i>
	<i><u>Evaders</u></i>	<i><u>Non-Evaders</u></i>
First Income Level (\$100)	49%	24%
Second Income Level (\$1,000)	52	27
Third Income Level (\$10,000)	90	27

At each income level about one-quarter of the "suspected non-evaders" were dissatisfied with the way the Income Tax Office had dealt with their annual return whereas, at each of the three levels, a statistically significantly greater percentage of "suspected evaders" were dissatisfied. The percentage of evaders who were dissatisfied rose from 49% at the first income level to 90% at the third income level, thus giving quite strong support for the administrative control hypothesis. The following conclusion was possible from the above results: taxpayers who are dissatisfied with the way their annual return is dealt with by the Income Tax Office are more likely to evade tax than those who are satisfied with the way in which it is dealt. However, it has to be conceded that it is possible the causation might be the opposite way around, i.e. people who evade are more likely to be dissatisfied with the way their annual return will be assessed!

With respect to the other two statistically significant results in Table 5.21 little can be said because both were accompanied by low totals for cell counts with the "suspected evader" group; ten (6% of sample) and eight (8% of sample) respectively, and with the latter the direction of the relationship was opposite that expected. Question 4(c) showed that 60% of "suspected evaders" were dissatisfied with the *time* the Income Tax Office took to deal with their annual return whereas only 26% of "non-evaders" were similarly dissatisfied, confirming perhaps, that the efficiency with which the Income Tax Office deals with taxpayers' affairs *might* influence the level of evasion. However, it ought to be emphasised that question 4(c) was influential for only one of the three tests.

The only conclusive results from all of the traditional analyses was that the administrative control hypothesis received some support. This was evident when respondents were classified into "suspected evaders" and "suspected non-evaders" according to their attitude to tax evasion. Each time taxpayers were so classified responses to question 4(a)(ii), the question relating to taxpayers' satisfaction with the way the Income Tax Office dealt with their annual return, showed a statistically significant difference. Consistently the "suspected evader" group were more dissatisfied with the way they had been treated.

Unfortunately this result was *not* repeated when taxpayers were classified into the same two groups using orientations to commit evasions. This could carry with it the implication that the choice of methodology can influence results. Generally, the two traditional methodologies did *not* conflict but this was because neither produced significant results. Apart from the *limited* support from *one* of the methodologies for *one* of the three hypotheses the only other conclusion

to be drawn from this section is that the traditional methodologies appear to be less satisfactory than that used in section 5.4.

In the next section of this chapter the writer returns to his own methodology, described in section 5.2, to analyse relationships concerning the background characteristics.

5.6 INFLUENCE OF BACKGROUND CHARACTERISTICS

Other studies have shown some significant differences between the background characteristics of evaders and non-evaders. In the evasion survey questions were asked to determine four background characteristics *viz.* age, employment status, income level and country of birth. The categories for which responses were solicited have been collapsed into 2 x 2 contingency tables and the results are given in Table 5.23.

TABLE 5.23

Background Characteristics of Evaders and
Non-Evaders

	<i>Evaders</i>	<i>Non-Evaders</i>
(a) Age - Under 40	23%	52%
40 and Over	<u>77</u>	<u>48</u>
	<u>100%</u>	<u>100%</u>
(b) Employment - Self Employed	43%	13%
Status Not Self Employed	<u>57</u>	<u>87</u>
	<u>100%</u>	<u>100%</u>
(c) Income - \$17,894 or less	60%	77%
Above \$17,894	<u>40</u>	<u>23</u>
	<u>100%</u>	<u>100%</u>
(d) Country - Australia	65%	81%
of Birth Not Australia	<u>35</u>	<u>19</u>
	<u>100%</u>	<u>100%</u>

In all four cases chi-square tests, at the 5% level of significance, showed a statistically significant difference between responses from the two groups.³³ Whether this means that there is a real difference between evaders and non-evaders is difficult to know. The results could merely reflect aspects of the Taxation Office's enforcement policy. For instance they might concentrate on taxpayers who are over forty, who are self-employed, who have high incomes and who were born outside Australia. Those in the evader group tended to be older, to be self-employed, to have slightly higher incomes and to be more often born outside Australia. These differences carry with them many possible implications. For instance, have older taxpayers learnt more ways to evade tax?; have self-employed taxpayers greater opportunity to evade?; have income earners more reason to evade because they face higher rates of tax?; and have taxpayers born in Australia greater commitment to the State? These possibilities and others were explored when the four background characteristics were compared with the main sets of questions for both evaders and non-evaders. For convenience the background characteristics and responses were reduced to 2 x 2 contingency tables. This meant that the ten cells were collapsed into four. Inevitably some information was lost but the direction of statistically significant relationships was more readily apparent and the problem of low cell counts was eliminated. The results follow.

5.6.1 The Influence of Age

An analysis of the influence of age on answers to the main sets of questions is given in Table 5.24. Only statistically significant chi-square values are shown.

TABLE 5.24

The Influence of Age on Respondents Answers,
Significant Chi-Square Values

Questions relating to	χ^2 Values ($df = 1$)	
	Evaders	Non-Evaders
1. The Exchange Control Hypothesis		
Q. 1(a)	5.981	-
1(b)	-	6.366
2(a)	-	4.407
2(b)	-	-
2. The Social Orientation Hypothesis		
Q. 2(c)	-	-
2(d)	-	12.354
6(a)	-	-
6(b)	-	-
6(c)	-	-
3. The Administrative Control Hypothesis		
Q. 4(a)(i)	-	9.413
4(a)(ii)	6.472	6.681
4(b)	-	-
4(c)	-	11.239
4. Taxpayers' Attitudes to Tax Evasions		
Q. 3(a)	-	6.377
3(b)	-	9.313
3(c)	-	-
5. Taxpayers' Opportunities to Commit Tax Evasion		
Q. 10(i)	-	4.394
10(ii)	6.871	5.738
10(iii)	-	-

Inspection of the three relevant contingency tables for evaders showed that a *smaller proportion* of those aged 40 years and over

- (i) thought that tax rates were too high (79% compared with 92% for those under 40 years of age);
- (ii) were satisfied with the *way* the Income Tax Office dealt with their annual returns (36% compared with 57% respectively); and
- (iii) thought that they had *no* opportunity to omit \$1,000 cash earnings from their annual returns (65% compared with 82% respectively).

Age tended to have more influence on responses received from non-evaders with it being significant in ten instances, compared with three for evaders. Again inspection of the relevant contingency tables was made and these revealed that a *smaller proportion* of those aged 40 years and over

- (i) thought that tax rates in relation to their earnings were *too high* (48% compared with 65% for those under 40 years of age);
- (ii) were satisfied with the way the Government in Canberra spent taxpayers' money (13% compared with 24% for those under 40 years of age);
- (iii) were *not* satisfied with the way they had been treated in dealings with Government Departments (49% and 73% respectively);
- (iv) were *not* satisfied with the *time* it took the Income Tax Office to deal with their annual return (17% and 37% respectively);
- (v) were *not* satisfied with the *way* the Income Tax Office dealt with their annual return (21% and 39% respectively);
- (vi) were *not* satisfied with "*official investigations*" by Income Tax Officers of their income tax affairs (57% and 87% respectively);
- (vii) approved of taxpayers omitting \$100 cash earnings from their annual return (17% and 33% respectively);
- (viii) approved of taxpayers omitting \$1,000 cash earnings from their annual return (7% and 22% respectively);
- (ix) indicated they had the opportunity to omit \$100 cash earnings from their income tax return (50% and 64% respectively); and
- (x) indicated they had the opportunity to omit \$1,000 cash earnings from their income tax return (14% and 28% respectively).

5.6.2 The Influence of Employment Status

When the influence of employment status was considered respondents were classified into two groups, *viz.* "self-employed" and "not self-employed". These categories were not defined and respondents were left to their own devices to determine which category applied to them. While this was not entirely satisfactory, alternative approaches would have made the question too long and too complex. The results for both samples are given in Table 5.25. Again only statistically significant chi-square values are given.

TABLE 5.25

The Influence of Employment Status on Respondents
Answers, Significant Chi-Square Values

Questions relating to	χ^2 Values ($df = 1$)	
	Evaders	Non-Evaders
1. Exchange Control Hypothesis		
Q. 1(a)	-	16.112
1(b)	-	-
2(a)	-	-
2(b)	-	-
2. Social Orientation Hypothesis		
Q. 2(c)	-	-
2(d)	-	-
6(a)	-	-
6(b)	-	9.848
6(c)	-	-
3. Administration Control Hypothesis		
Q. 4(a)(i)	-	-
4(a)(ii)	-	-
4(b)	-	-
4(c)	4.475	-
4. Taxpayers' Attitudes to Tax Evasion		
Q. 3(a)	-	-
3(b)	-	-
3(c)	-	-
5. Taxpayers' Opportunities to Commit Tax Evasion		
Q. 10(i)	-	-
10(ii)	-	-
10(iii)	-	-

Surprisingly responses from self-employed taxpayers gave statistically significantly different answers in only three instances, and only one of these was from the sample of convicted evaders. This latter difference related to the question on "official investigations" of taxpayers' income tax affairs. It was found that 13% of self-employed evaders were "satisfied" with this experience whereas 25% of those not self-employed were "satisfied" with it.

With respect to the sample from the general population it was found that questions 1(a) and 6(b) produced significantly different responses. In relation to the first question, 58% of those who were "self-employed" thought that tax rates were too high whereas 88% of non self-employeds thought they were too high. Self-employed persons thought that they knew more associates omitting \$1,000 cash earnings from their income tax returns than did their counterparts.

5.6.3 The Influence of Income

While employment status produced few significant differences income produced nine such differences. Of these, five related to the *one* set of questions *viz.* those concerning taxpayers' opportunity to commit small and large scale evasions. For evaders, differences emerged on all three questions [questions 10(i)-10(iii)] and for non-evaders on two out of three. Table 5.26 provides a list of chi-square values where significant results were obtained.

For both groups there was a positive relationship between income and perceived opportunity to evade tax and at *each* level a greater proportion of those from the high income group thought they had the opportunity to successfully evade tax. The relationships are summarised in Table 5.27.

TABLE 5.26

The Influence of Income on Respondents' Answers,
Significant Chi-Square Values

Questions relating to	χ^2 Values (df = 1)	
	Evaders	Non-Evaders
1. Exchange Control Hypothesis		
Q. 1(a)	-	-
1(b)	-	-
2(a)	-	-
2(b)	-	-
2. Social Orientation Hypothesis		
Q. 2(c)	-	-
2(d)	-	-
6(a)	-	16.361
6(b)	-	9.745
6(c)	-	-
3. Administrative Control Hypothesis		
Q. 4(a)(i)	-	-
4(a)(ii)	7.290	-
4(b)	-	-
4(c)	-	-
4. Taxpayers' Attitudes to Tax Evasion		
Q. 3(a)	-	-
3(b)	-	-
3(c)	5.716	-
5. Taxpayers' Opportunities to Commit Tax Evasion		
Q. 10(i)	7.899	3.996
10(ii)	4.194	5.724
10(iii)	6.137	-

TABLE 5.27

Percentage of Respondents Who Said That They Had The
Opportunity to Successfully Hide Cash Earnings

Income Level	Evaders		Non-Evaders	
	High	Low	High	Low
	Income	Income	Income	Income
	%	%	%	%
\$100	60	40	70	54
\$1,000	29	17	34	18
\$10,000	12	3	N.A.	N.A.

It was interesting to note that at the \$100 level and the \$1,000 level the percentage from the general population who thought they had the opportunity to successfully hide cash earnings was higher than the corresponding percentage from the convicted evader group.

Evaders with high incomes tended to be *less* satisfied with the *way* the Income Tax Office dealt with their annual returns (41% were satisfied compared with 60% from the low income group, though this result might merely reflect the fact that they paid more tax. Also a greater proportion of evaders approved of large scale evasions. Some 16% approved of taxpayers omitting income of \$10,000 whereas only 6% from the low income group approved of this (an instance of peer group influence?). The significant results, from the general population group, showed high income earners tended to know more small and medium scale evaders than the low income group.

5.6.4 The Influence of Country of Birth

As with employment status country of birth produced few statistically significant differences as Table 5.28 shows. Only four differences were obtained, three with the evader group and one with the general population. Inspection of the relevant contingency tables showed that in respect of the latter, 18% of the general population respondents who were born outside Australia were satisfied with non-tax laws whereas 42% of those born in Australia were satisfied. For evaders a greater proportion of Australian born taxpayers considered tax rates were too high (for q.1(a) 93% compared with 81% and for q.1(b) 60% compared with 43%). This pattern was opposite to that expected! In relation to q.3(a) the direction of the difference was as expected but the difference was obtained on only one of the three parts of question 3. For q.3(a) 27%

of Australian born evaders approved of small scale evasions compared with 40% for those not born in Australia.

TABLE 5.28

The Influence of Place of Birth on Respondents' Answers, Significant Chi-Square Values

<i>Questions relating to</i>	<i>χ^2 Values ($df = 1$)</i>	
	<i>Evaders</i>	<i>Non-Evaders</i>
1. Exchange Control Hypothesis		
Q. 1(a)	7.762	-
1(b)	5.429	-
2(a)	-	-
2(b)	-	-
2. Social Orientation Hypothesis		
Q. 2(c)	-	7.286
2(d)	-	-
6(a)	-	-
6(b)	-	-
6(c)	-	-
3. Administrative Control Hypothesis		
Q. 4(a)(i)	-	-
4(a)(ii)	-	-
4(b)	-	-
4(c)	-	-
4. Taxpayers' Attitudes to Tax Evasion		
Q. 3(a)	4.039	-
3(b)	-	-
3(c)	-	-
5. Taxpayers' Opportunities to Commit Tax Evasion		
Q. 10(i)	-	-
10(ii)	-	-
10(iii)	-	-

5.6.7 Other Remarks About The Background Characteristics

Had there been time and space other aspects of the background characteristics could have been explored. For instance, responses of the two groups could have been compared holding the background

characteristics constant. Thus when considering the first background characteristic (age), responses of the evaders aged under 40 could have been compared with responses of similar non-evaders. This procedure could have then been repeated for the seven other categories in Table 5.23. Although this would have meant another 104 calculations* (i.e. 8 categories times 13 questions) some important results could have been obtained. These further calculations were not made because the author did not believe that background characteristics *alone* could explain taxpayers' motives.

This aspect could be a fruitful area of future research. Not only could the four background characteristics obtained here be used, but also other characteristics such as education, sex, marital status and political party preference. Some control mechanism could be used to exclude from the "non-evader" group those taxpayers suspected of being evaders. As well as considering the effects of background characteristics on respondents' attitudes one could also determine their effect on, or their relationship with, taxpayers' perceived opportunity to evade tax, taxpayers' fiscal knowledge etc. Some sort of model could then be developed showing the relationship and inter-relations between all these factors. Care would have to be taken, of course, to exclude the influence of any inter-relation between the background characteristics. For example it is conceivable that age and income might be positively related, as might income and education. Unfortunately, all of this was beyond the scope of this thesis.

5.7 COMMENTS ABOUT TAX EVASION

5.7.1 General Comments

An attempt is made in this section to summarise some of the comments made about tax evasion. At the end of the questionnaire free

* This becomes 208 calculations if the original categories rather than the collapsed categories are used.

space was provided to allow respondents to express their feelings about tax evasion. They were prompted with the following preamble:

Use this space to tell me more about your feelings on the questions asked in this survey. For instance, you might like to tell me why you *think* people feel justified in evading tax or how some people can evade tax but others cannot.

About two-thirds of those who responded made comments and this provided almost two hundred and seventy additional sources of information. About the same number from each group made comments; however, the comments received from evaders tended to be longer and more forcefully put. No attempt is made to summarise all the comments. Only those relevant to the main thrust of this thesis are considered. Apart from the strength of their feelings evaders tended to have a different attitude towards income tax and tax evasion. It was not easy to pinpoint this difference nor was the difference evident between all evaders and all non-evaders. Many non-evaders appeared to hold the same views as evaders. If there was a difference it was that evaders tended to justify their evasions whereas non-evaders believed that "honesty [was] the best policy". For instance, the following seem to depict the difference the writer saw:

Evader

Having been investigated and ordered to pay \$11,000 for income not declared I naturally feel strongly. As a journalist who works hard and spends long hours doing extra work it is felt there is no encouragement to do extra work if it all goes in tax. Therefore we all tend to want to cheat and take the risk.

Non-Evader

It is a fact of life that nobody likes to pay tax and I am no different to the next person; but I am aware of my social responsibility.

Some comments made by non-evaders were obviously with tongue in cheek. One non-evader said "I would never cheat on my income tax return; that is if I ever had one." Differences between the two groups were also evident in the *perceived effects* of tax evasion as the next two comments show:

Evader

I have evaded tax, was investigated and fined. I have been working since to pay it off. Meanwhile my business has dropped, my incentive gone, my staff dismissed, I'm in debt. For the last three years the Taxation Department has received 92-1/2% less than I paid when business was good. They have 'killed' a very good source of income.

Non-Evader

I am against people evading tax in large amounts because they in turn are the reason that our tax rates are so high.

Both groups expressed grave concern on two issues: firstly, the lack of opportunity for wage and salary earners to evade tax and therefore the consequent shift of the weight of tax burdens; and secondly, the deleterious effects of high rates of tax on the incentive to work. Though the next two comments come from evaders the comments reflect the views of many respondents in both groups:

I think the average wage and salary earner believes he is carrying more of the tax burden than the professional man because he has less chance of claiming business deductions. If he were in the same position he would probably do the same thing, but while the discrepancy exists so does the resentment.

Very few staff under me will work any overtime ... when I ask them, invariably they say ... 'sorry but not for 54 cents in every dollar I earn'. There is no inducement for the average wage and salary earner to earn as much as he can because of the extortionately high rate of income tax.

Both groups of respondents also agreed that greatest opportunity to evade tax existed with self-employed persons, independent tradesmen,

farmers and "cash businesses such as milkbars, fruitshops and other retail shops". Apart from failure to declare all income received, respondents also believed these people made either "fictitious claims for depreciation, heating and petrol" or "overstated deductions for travelling expenses, entertainment and telephone".

The remaining comments are summarised under the headings of the three main hypotheses that were tested by the survey with the addition of comments about various reform proposals.

5.7.2 Comments about the Exchange Relationship Hypothesis

By far the greatest number of comments made related to the exchange relationship hypothesis. This was true for both evaders and non-evaders. Evaders, in particular, justified their actions because they saw tax rates were too high, because they believed high income earners had more opportunity to *avoid tax* and because they felt the Government wasted taxpayers' money. The following comments from evaders are typical of those received. The numbers in square brackets indicate the number of evaders who made similar comments.

Evaders' comments about tax rates

Lower income earners should feel justified in evading tax because they pay the majority of it anyway. Companies and large income earners have more loopholes from which to [avoid] tax. [39]

I think people are justified in trying to evade income tax for the simple reason that the present tax scale is too high. [21]

I think taxation is too high, it takes away the incentive to work and forces a lot of workers to try to dodge their taxation responsibilities. [14]

Some people feel cheated by the Government. What do they do with all the money? [14]

I think people would not try to evade paying tax if they thought the Government was handling the spending of public money efficiently. [12]

Those who complained about waste in Government spending specified areas which caused most complaint. These included too many public servants who were paid too much for doing too little, and who received excessive superannuation payments on retirement; too many 'freeloaders' on social security pensions; too many other abuses of social welfare schemes and too much spent on 'useless armaments'.

At least ten respondents did not agree that payment for working overtime should be taxed. As one put it: "if you work overtime and save I reckon the tax scale should be reduced ... taxing overtime leads people to become dishonest and cheat." One respondent even referred to the taxation of overtime as 'legal slavery'. Taxation of another source of income also seemed to cause a great deal of resentment. The views of sixteen convicted evaders are summarised in the following comment:

People saving in banks and building societies should not pay tax on interest earned because they have already paid tax when they earned the money in the first place.

Other inequities in the tax system also caused concern. Few taxpayers approved of *provisional tax*. One respondent believed that this method of payment of tax was the 'real killer'. Another, a "non-evader"(?), said that if he "didn't evade some tax he wouldn't be able to pay his provisional tax". Among reasons given by non-evaders for tax evasion were:

It is usually the small income earner that gets caught evading tax - not the large one (\$50,000 plus) that avoids tax and deserves to be caught. [21]*

The Government wastes millions so why not cheat a little wherever possible. [18]

People who work hard are justified in evading some tax because tax rates are too high. [17]

How can they justify taking it from you for overtime? [11]

Wage and salary earners are carrying the Australian tax burden as opposed to businesses and rural industries. [8]

From discussions with others I gather that undeclared income is their way of registering dissatisfaction with the tax system and the general state of Government policy. [4]

People feel justified in evading tax to maintain living standards. [4]

There is one tax law for people on low incomes and another for those on high incomes. [4]

[*N.B. Numbers in square brackets again represent the number of respondents who expressed similar views.]

5.7.3 Comments about the Social Orientation Hypothesis

Very few comments were received from either group about the hypothesis the author refers to as the social orientation hypothesis. Judging from the four comments which were received, at best, this could only be the cause of some secondary evasion. The four comments were:

Italians form companies so why shouldn't we. (an evader)

If one were to study the annual publication of tax evaders one would note that they mainly have foreign names.
(an evader)

Government staff are not friendly and do not try to help.
(an evader and two non-evaders).

5.7.4 Comments about the Administrative Control Hypothesis

Apart from the exchange relationship hypothesis most comments concerned the administrative control hypothesis. Most comments were received from those who had been convicted of tax evasion and these people tended to be dissatisfied with the way they had been treated by the Tax Office.

Evaders' Comments

In 1979 I went before the Taxation Board of Review. Officially I lost the case. I believe the hearing was rigged ... I have heard of another case of trickery used to try to get payment from a taxpayer.

The investigation is arranged so that you must be found guilty.

I think the tax system is biased ... all they have to do is to assess you and you have to prove to them that you are right, ... if you are wrong, surely, they have to prove it not you. I think they have too much power.

Try dealing with the Taxation Office - write a letter of complaint on a tax assessment, they don't bother replying. Just fine you for late payment of excess tax at 10%. Still try to get an answer and when you do it says see part xyz of section abc subsection q of some bloody Income Tax Act which of course they don't send you ... If the Taxation Department sacked all those without manners and those who were incompetent then people would be a lot happier. I don't mind paying tax but I expect service ...

In my opinion fines for evading tax are not uniform - from one who knows!

The saddest part about taxation is that people who work hard are sometimes penalised and only some are caught.

I don't think the tax people investigate the big man as much as they should. They are too busy chasing the small people for a few dollars.

Fewer comments were received from non-evaders and those comments which were received had a mixture of purposes.

Non-Evaders' Comments

Taxation Departments should be *fully* staffed with expert inspectors.

You tend to get a little upset with Government Departments when your accountant sends your tax return in and you don't hear or see anything for twelve months. Especially when you are counting on the money ...

I personally believe it doesn't harm to evade paying a small amount of tax but I was once called to the Taxation Board of Review to verify my deductions against my income and at the time I worked in the Taxation Department. It wasn't a pleasant experience even though they could find no fault with my return.

I feel *all* deductions should be classified and not left to individual assessors to judge ... If the present haphazard system continues discontent will surely escalate.

5.7.5 General Comments about Tax Reforms

Reform proposals were more forthcoming from the evader group. Five wanted income tax to be replaced by some form of indirect tax while a similar number preferred income tax to be retained but with a single proportional rate of tax. Others felt indexation of the tax rates should be reintroduced or that alternative taxes such as wealth tax, death duties, turnover tax and even poll taxes should be considered. With respect to penalties one evader suggested that "the Tax Department should differentiate between tax evaders. First offenders should attract lesser penalties as some people misinterpret the law."

The main reform proposal suggested by non-evaders, five of them, was the introduction of a flat rate tax. Others suggested a shift from income tax to resources taxes in the mining industry.

5.8 SUMMARY

Comments made by evaders suggested that the exchange relationship was the most important hypothesis explaining why taxpayers felt justified in evading tax. Among the feelings of those who made comments were that they were not getting value for their tax dollar, that tax rates were too high, that the Government did not spend taxpayers' money wisely, that the burden of taxes fell disproportionately on low income earners, that the rich avoided tax by employing tax specialists and that other aspects of the tax system caused inequities. There was ample quantitative support to verify these claims; for instance, Table 5.7 showed:

- (i) 89% of evaders thought that tax rates were 'too high' in relation to the amount they earned;
- (ii) 54% of evaders thought that tax rates were 'too high' in relation to the amount of Government services that they received;
- (iii) 72% of evaders were dissatisfied with the way the Federal Government spent taxpayers' money; and
- (iv) 82% of evaders were dissatisfied with our income tax laws.

However, in section 5.4.1 when responses from the general population were compared with those received from evaders, there was no statistically significant difference between the two groups on any of the four questions. This was so because there was also widespread belief among the general population that taxpayers' *terms of trade* with the Government were unfavourable. Table 5.7 also showed that:

- (i) 85% of the general population thought that tax rates, in relation to earnings, were 'too high';
- (ii) 57% of the general population thought that tax rates, in relation to Government services received, were 'too high';
- (iii) 73% of the general population were dissatisfied with the way the Government spent taxpayers' money; and
- (iv) 75% of the general population were dissatisfied with our tax laws.

Because the chi-square tests revealed no difference in responses between the two groups the first reaction was to suggest that the exchange relationship hypothesis did not explain why evaders evaded tax. However, after analysing the comments received one was left with the distinct impression that this was the major cause of most tax evasion. Therefore, an alternative interpretation of the null hypothesis about the exchange

relationship was required. The author felt it could be this: that there were just as many evaders in the sample from the general population as there were in the sample of convicted evaders!

The suggestion that many of those in the general population evade tax (rather than the alternative possibility that there were just as few evaders in both groups) was, to an extent, borne out by the answers to question 9 which asked "when completing an income tax return, what do you think someone like yourself would do about cash earnings from a part-time job if they amounted to (i) \$100, (ii) \$1,000, and (iii) \$10,000?". Responses indicated no difference between the percentage of evaders who said that they would omit the specified amounts and the percentage from the general population who would omit them as Table 5.29 shows. [N.B. There is always some doubt whether these stated intentions would, if the opportunity arose, be translated into actual behaviour.]

TABLE 5.29

Percentage of Taxpayers who Said That They
Would Omit Cash Earnings from a Part-time
Job

<i>Amount of Cash Earnings</i>	<i>Evaders</i>	<i>Non-Evaders</i>
\$100	65%	69%
\$1,000	24	26
\$10,000	6	6

Answers to question 10 revealed that the orientation to commit tax evasions, suggested by Table 5.29, might have been translated into taxpayer action because a substantial proportion of both groups said they had *the opportunity to successfully hide income* from the tax man. The results of answers to question 10 are summarised in Table 5.30.

TABLE 5.30

Percentage of Taxpayers Who Said That They Could
Successfully Hide Income from the Tax Man

<i>Amount</i>	<i>Evaders</i>	<i>Non-Evaders</i>
\$100	48%	58%
\$1,000	22	21
\$10,000	7	2

Given widespread opportunity to evade and given a high degree of association between intention and action it could be concluded that small scale evasion could be widespread!

Comments from both groups did not suggest that the social orientation hypothesis was significant as a cause of tax evasion. However analysis of variance tests on answers to question 6 showed that evaders, on average, knew more evaders than did non-evaders. Prior theory suggested that people learned how to evade from those who are successful and that peer group pressure can influence behaviour. The results obtained tended to support this view and it seems that this hypothesis might explain some *secondary* evasion, if not some primary evasion.

The third hypothesis produced significant difference in responses for three of the four questions. The only question not producing any difference related to provisional tax. But this seems to have been caused by the fact that roughly the same *majority* (about 75%) in both groups were *dissatisfied* with this method of tax payment.

With respect to the other questions the most important, according to comments received was question 4(c). It suggested that taxpayers' level of satisfaction with the way they had been treated by the Tax Office during official investigations might be an important influence on future levels of tax evasion. Some 65% of evaders who were investigated by the

Income Tax Office were *dissatisfied* with the way they had been treated whereas only 37% of non-evaders were dissatisfied. The difference is perhaps explicable, no-one likes to be caught for doing wrong. But the comments received indicated that it was the *way* taxpayers were treated that caused resentment. This could result in further evasions. Responses and comments on this question and analysis of administrative practices, in Chapter Three, suggests that if evasion is to be reduced, then a full-scale review of Tax Office practices and procedures should be carried out.

This chapter is closed with the following comments: firstly from one evader - "the payment of tax is voluntary; those who want to pay it will and those who don't, won't." Collection of tax in the long term requires the co-operation of taxpayers. If a tax system is to succeed then it must be equitable, it must be administered fairly and above all it must be seen to be equitable and administered fairly. Secondly, there now seems to be evidence, in Australia, that tax evasion is *more than* "a rich vein of anecdotes without necessarily being a quantitative phenomenon of quantitative significance", as Dilnot and Morris suggest for some European countries.³⁴

FOOTNOTES TO CHAPTER FIVE

1. It was necessary to limit the survey to this one aspect of tax evasion otherwise the questionnaire and this chapter would have been far too cumbersome. Ideally, if time, space and money had permitted the same hypotheses could have been tested with respect to other aspects of tax evasion, e.g. overclaiming on deductions or rebates and non-payment of tax by the due date.
2. I wish to acknowledge the assistance of the Taxation Institute's Research and Education Trust which provided a grant of \$2,000 for this purpose.
3. I wish to acknowledge the assistance of Dr. Mark Tippet for deriving the formula:

$$n > \frac{N}{1+4\pi\lambda^2(N-1)}$$

where n = sample size

N = population size

π = confidence limit

λ = tolerance limit

from Chebyshev's theorem, and for his help in applying the Camp-Meidell Inequality. Reference to this Inequality can be found in H. Freeman, *Introduction to Statistical Inference*, Reading, Massachusetts: Addison-Wesley Publishing Co., 1963, at p.4.

4. C.A. Moser and G. Kalton, *Survey Methods in Social Investigation*, London: Heinemann Educational Books, 1979, at p.53.
5. *Ibid*, p.53.
6. Section 16(2) of the *Income Tax Assessment Act* 1936 as amended provides that an officer shall not either directly or indirectly divulge or communicate to any person any such information acquired by him. There are some exceptions to this - see s.16(4) of the same Act.
7. At 30 November, 1981 the Commonwealth Rolls were made up as follows:

*Dates to which Commonwealth Electoral Rolls
were made up*

<i>State or Territory</i>	<i>Main Roll</i>	<i>Supplementary Roll</i>
A.C.T.	19 September 1980	n.a.
N.S.W.	31 July 1981	28 August 1981
N.T.	19 September 1980	n.a.
QLD.	4 August 1980 (a)	19 September 1980
S.A.	19 September 1980	n.a.
TAS.	12 August 1980	n.a.
VIC.	30 March 1981	28 August 1981
W.A.	1 August 1980 (b)	19 September 1980

(a) Except for the electorate of McPherson which was made up to 27 January 1981.

(b) Except for the electorate of Curtin which was made up to 27 January 1981.

8. P.L. Erodos and A.J. Morgan, *Professional Mail Surveys*, New York: McGraw-Hill, 1970, p.102.
9. This required over three thousand signatures and three thousand 'first names' being written.
10. A.N. Oppenheim, *Questionnaire Design and Attitude Measurement* (London: Heinemann Educational Books, 1979) states that late respondents and non-respondents are roughly similar.
11. Non response bias was evident at the 5% level of significance as follows:

Question	χ^2 Value	df
1(a)	9.727	3
4(a) (ii)	14.270	4
10(i)	11.335	4

where $[p(\chi^2_{0.05}, 3 > 7.8147) = 0.05]$

12. For each of these three questions, for which there was non response bias, new estimates of the population proportions were obtained. This was done by extrapolating the 'late respondent' profile to the non-respondents. When this was done the chi-square values for 2x2 contingency tables, comparing responses from evaders and non-evaders, provided the following results:

Question	χ^2 Value	Result
1(a)	0.02	No significant difference*
4(a) (ii)	13.72	Significant difference*
10(i)	18.69	Significant difference**

* i.e. same result as obtained from unadjusted data.

** N.B. different result than that obtained from unadjusted data.
Further comments incorporated in 5.4.

13. A.N. Oppenheim, *op. cit.*
14. *Ibid*, p.153.
15. *Ibid*, p.153.
16. The respective χ^2 values were:

Q.3(a)	11.405
3(b)	20.583
3(c)	13.310
10(ii)	10.016

 where the critical value at df=4 was 9.4877.
17. Chi-square values of 6.150 (df=4) and 8.427 (df = 4) respectively were obtained and $p(\chi^2_{0.05}, 4 > 9.4877) = 0.05$.
18. The two categories were "Too High" and "Not Too High" and the chi-square value obtained was 1.802 where $p(\chi^2_{0.05}, 1 > 3.841) = 0.05$.
19. Chi-square values of 1.089 (df=4) and 4.481 (df=4) respectively were obtained and the critical value was 9.4877.
20. Evaders (184) and non-evaders (173) combined as a percentage of total responses (412).
21. Evaders (149) plus non-evaders (149) as a percentage of the total (412).

22. Evaders (169) plus non-evaders (152) as a percentage of the total (412).
23. For question 2(c) the χ^2 value obtained was 10.405 (df = 4) where the critical value was 9.4877.
24. For question 2(d) the χ^2 value obtained was 2.555 (df = 4) where the critical value was 9.4877.
25. But W.J. Conover, *Practical Non Parametric Statistics*, New York: John Wiley & Sons, 1970 suggests that where at least 20% of the cells have counts of five or more the test is still a good approximation; at p.152.
26. The columns in the 2x2 table were evaders and non-evaders and the rows 'satisfied' and 'not satisfied'. The χ^2 value obtained was 1.052 and the critical value for df=1 was 3.8415.
[N.B. The satisfied group included those who were 'very satisfied' or 'somewhat satisfied' whereas the 'not satisfied' group contained the other three categories.]
27. The results obtained were:
Q.6(a) F value obtained 10.91 (df=1, 410); critical value 3.841.
6(b) F " " 16.70 " " " " 3.841.
6(c) F " " 1.34 " " " " 3.841.
[N.B. 'Welch' and 'Brown-Forsythe' statistics were obtained to see whether unequal variances within groups made any difference. These made no difference to the answers obtained above, i.e. there was a statistically significant difference on 6(a) and 6(b), but not on 6(c).]
28. Chi-square values obtained were: Q.4(a)(i) 10.729
4(a)(ii) 15.551
4(b) 4.207
4(c) 28.923
and in all cases the critical value (df=4) was 9.4877.
29. A χ^2 value of 9.538 was obtained where the critical value (df=4) was 9.4877.
30. For instance see Y. Song & T.E. Yarbrough, "Tax Ethic and Taxpayer Attitudes: A Survey", *Public Administration Review*, Sept/Oct 1978, pp.442-452.
31. For instance see M.W. Spicer and S.B. Lundstedt, "Understanding Tax Evasion", *Public Finance*, 1976, pp.295-305.
32. Analysis of variance analysis test was carried out and the F value obtained was 3.55 and for df=1,203 at p=0.05 the critical value was 3.841.
33. Chi-square values of 36.928, 45.791, 14.059 and 13.890 respectively were obtained and the critical value with one degree of freedom was 3.841.
34. A. Dilnot and C. Morris, "What Do We Know about The Black Economy", *Fiscal Studies*, Vol.2, No.1, March 1981.

CHAPTER SIX

A SURVEY ON TAX AVOIDANCE

6.1 SURVEY OBJECTIVES

Two main purposes were served by the survey on tax avoidance. First, it helped determine what *tax agents* thought most influenced taxpayers to undertake tax avoidance schemes and second, it helped determine how *tax agents* felt about various reform proposals. At the outset it should be stated why tax agents were surveyed and not taxpayers. The reason was quite simple: it lay in the meaning of the term "tax avoidance", which can have different meanings for different people. In the context of this survey tax avoidance meant reduction in one's tax liability by blatant, artificial or contrived means. It was felt that tax agents would be in the best position to understand this meaning and to know what might have motivated taxpayers to undertake avoidance of this type.

The precise meaning of the term "tax avoidance" in this survey was explained at the front of the questionnaire:

The aim of this survey is to find out more about *tax avoidance* which, *for the purpose of this survey*, means "reduction of one's tax liability by means which are within the letter of the law but against its spirit".

Such practices

- * take advantage of loopholes in the tax laws;
- * are carried out by complex legal manoeuvres;
- * appear to be somewhat artificial; and
- * depend for their success on some degree of secrecy.

The survey was pretested by means of a pilot survey and two questions were asked to see whether tax agents were aware of what was meant by the term "tax avoidance". Tax agents were asked whether they knew how a typical tax avoidance scheme worked. Responses showed that 90% had

heard of the scheme and 70% knew how the scheme worked. Ideally, one would have liked to have surveyed taxpayers who had engaged in tax avoidance schemes to see why they had participated. However, it was quite impossible to know which taxpayers had participated. No official lists of names of tax avoiders are published and attempts to generate such lists by asking taxpayers about their income tax activities were considered to be quite fruitless. As an alternative, it was thought that tax agents might be a valuable source of information. In many instances tax agents either implemented such schemes or advised their clients whether or not they should carry them out. Therefore it was decided that tax agents probably were in the best position to know what was meant by the term "tax avoidance" *and* to know what might have motivated some taxpayers to engage in it.

Suggested reforms often fail because they are quite impractical. On other occasions they fail because they do not have popular or professional support. Therefore, if suggestions are to be made about how tax avoidance can be reduced then some attempt must be made to see whether potential reforms are practical or whether they have such support. The tax avoidance survey attempted to address these issues as well as the motivational basis of tax avoidance. The questionnaire is reproduced in full in Appendix 2. The reason for asking particular questions is given in Table 6.1.

6.2 SURVEY METHODOLOGY

6.2.1 General Methodology

As with the survey on tax evasion it was evident that the only possible way of conducting a nationwide survey was by way of mail

TABLE 6.1

The Purpose of Questions in the Tax Avoidance
Survey

<i>Question(s)</i>	<i>Purpose(s)</i>
6	To determine what tax agents think most influences taxpayers to engage in tax avoidance.
7	To determine what tax agents think most often discourages taxpayers from undertaking tax avoidance schemes.
1, 2(b)-(f) 3,4,5	To determine tax agents attitudes to various matters, including the tax system and its administration, tax avoidance, relations with the Income Tax Office and various reform proposals.
8	To determine the possible influence of high rates of tax on the incentive of professional people to work.
9	To determine the background characteristics of respondents.

questionnaire. Using the same statistical means used in the tax evasion survey,¹ it was found that to reduce to 5% the probability of the actual sample proportion being more than 2.5% removed from the population proportion would have required a sample size of over 6,000. The resources available limited the sample to a maximum of about one thousand. The survey population consisted of a random sample (n=1,000) of tax agents in Australia who at 30 June 1981 were shown in the Gazette² as being registered, under s.251J of the *Income Tax Assessment Act*, as tax agents. Approximately one in every twenty-five agents was included in the survey. They were sent a four page questionnaire, an explanatory letter and two incentives to reply. The first incentive was the offer of a copy of the results and the second a biro. A follow-up letter was sent two weeks after the questionnaire was mailed. Limited funds did not permit the sending of advance letters or second follow-up letters. Relevant details about the pilot survey follow in 6.2.2.

6.2.2 Pilot Survey on Tax Avoidance

Survey questions were pretested by means of a pilot survey conducted in March/April 1981, however limited resources restricted the pilot survey in two ways. Firstly, the sample size was only one hundred and secondly, the population frame was limited to tax agents who were registered in New South Wales. [N.B. The full-scale survey involved one thousand tax agents from all over Australia.] The pilot sample was divided into two groups to see whether offering an incentive to reply would make any difference in response rates. A black biro was included in fifty envelopes but not in the others. Responses from those receiving this incentive were greater than those not receiving it. At the 5% level of significance a one-tail test produced a 'z' value of 1.7645 whereas a value less than 1.645 ought to have been obtained if there was to be no difference.³ The result then was statistically significant. Group total responses were

TABLE 6.1A

Responses for the Pilot Survey on Tax Avoidance

	<i>Incentive Group</i>	<i>No Incentive Group</i>	<i>Total</i>
Total mailings	50	50	100
Number returned unopened	3	6	9
Effective mailings	47	44	91
Usable responses	34	24	58
Response rate: i.e.			
$\frac{\text{usable responses}}{\text{effective mailings}} \times \frac{100}{1}$	74%	53%	64%
	=====	=====	=====

The overall response rate was 64% and this was considered to be most satisfactory. A significantly higher response rate was expected in the full scale survey because all tax agents selected in the sample were to be sent a biro with their questionnaires. [N.B. In fact when the full

scale survey was conducted there was no difference. The overall response rate was almost exactly the same!]

The main questions in the pilot survey were questions four and five which sought tax agents' views on two things, *viz.* why taxpayers went in for tax avoidance and what was likely to discourage them. The questions and responses are given below:

Q.4 In your opinion, why do taxpayers *most* want to engage in *tax avoidance* schemes?

	<u>Answers</u>
They think the amount of tax they pay in relation to the amount of money they earn is too high.	48
They are persuaded by people selling the schemes that they will be better off.	1
They want to emulate others who have successfully engaged in tax avoidance schemes.	2
They are dissatisfied with the way the government spends taxpayers' money.	1
They are dissatisfied with the treatment they have received from the Tax Office and want to get even.	6
Total	<u>58</u> =====

Q.5 Which of the following do you think would *most* often discourage taxpayers from undertaking tax avoidance schemes?

	<u>Answers</u>
The costs associated with implementing those schemes.	11
The possibility of a protracted legal battle with the Tax Office over those schemes.	24
The complexity of the scheme.	5
The expectation that benefits will only be temporary.	12
The fear of public exposure of their tax affairs.	5
Other	<u>1</u>
Total	<u>58</u> =====

Responses to question four showed that the vast majority of respondents (80%) thought that high tax rates were the chief influence on taxpayers' behaviour. In view of the importance of this question it was decided to provide some new alternatives in the full scale survey and to move the first alternative in question four lower down the order. Similarly, with question five, it was decided to move the most popular answer to a position lower in the order. Other minor changes were made to some questions and *a new set of questions was added* because the new anti-avoidance legislation was introduced after the pilot survey was carried out. Of particular interest was whether tax agents:

- (i) approved of the new provisions;
- (ii) thought the new provisions would be effective in preventing tax avoidance; and
- (iii) felt taxpayers would, as a result of the new provisions, be more willing or less willing to engage in tax avoidance.

The additional questions were not pretested by way of a second pilot.

6.3 SURVEY RESPONSES

Only responses received within fifty days after the questionnaires were mailed were included in these results. Of the 1,000 questionnaires sent out thirty were returned unopened and 590 responses were received. Only 10 of these responses could not be used making the effective response rate 60%.⁴ Responses were classified by date of receipt with 'late' responses being assumed to be those received after the follow-up letters had been mailed. This enabled tests to be carried out to see whether there was any bias in the results because 40% of the population had not replied. The 'late' respondent category was assumed to be an

accurate reflection of the likely responses from those who did not reply.⁵ A chi-square independence test was then used to test for non-response bias. It was found that, for all questions, there was no statistically significant difference between the responses from the 'early' and 'late' categories. This evidence suggested that there was no bias in the results because of non-response from 40% of the population.

The number of tax agents requesting a copy of results was 341 or almost 60% of those who responded to the survey. This perhaps reflects the topical nature of the subject area as much as interest in the research itself.

6.4 REASONS GIVEN FOR TAX AVOIDANCE

The two main questions in the full scale survey were questions six and seven which asked tax agents "why they thought taxpayers went in for tax avoidance" and "what they thought would most discourage taxpayers from undertaking tax avoidance schemes". The questions offered a number of alternatives which had been modified as a result of answers given to similar questions in the pilot survey.⁶ Question 6 and the responses to it are reproduced below.

A number of those marking "Other" as the reason for avoidance in question six considered that the cause was a combination of the alternatives specified. A vast majority, almost three-quarters, felt that it was simply a matter of tax rates being too high. This was consistent with the results obtained from the pilot survey and supports the "exchange relation" hypothesis (Table 2.3). In fact, question six contained three alternatives which related to the exchange hypothesis (*viz.* alternatives one, three and five) and these accounted for 84%

Q.6 In your opinion, why have taxpayers *most* wanted to engage in *tax avoidance*?

	<u>Number</u>	<u>%</u>
They have thought the tax laws have been unfair.	39	7
They have wanted to emulate friends they have known who have successfully engaged in tax avoidance.	30	5
They have been dissatisfied with the way the government has spent taxpayers' money.	16	3
They have been dissatisfied with the treatment they have received from the Income Tax Office and have wanted to get even.	-	-
They have thought the amount of tax they have paid in relation to the amount of money they have earned has been too high.	428	74
Other (please specify)	67	11
	<u>580</u>	<u>100%</u>

of responses. The alternative relating to the social orientation hypothesis (*viz.* alternative two) received 5% of responses and the alternative relating to the administrative control hypothesis received no support at all.

When the respondents' background characteristics were compared with their answers to question six, it was found that there was no difference in answers because of professional membership or because a tax agent was actively engaged in taxation practice. However, there was a statistically significant difference of opinion according to the number of years respondents had been registered as tax agents. Table 6.2 shows the analysis of these two variables.

Though both groups considered high tax rates to be the major cause of tax avoidance respondents who had been registered for ten years or more were more prepared to suggest alternative reasons than were

TABLE 6.2

Analysis of Most Likely Causes of Tax Avoidance
and Number of Years Registered as a Tax Agent

	<i>No. of Years Registered</i>	
	<i><u>Less Than Ten Years</u></i>	<i><u>Ten Years or More</u></i>
Tax Rates Too High	80%	68%
Some Other Reason	<u>20%</u>	<u>32%</u>
	100%	100%
	====	====

respondents who had been registered for less than ten years. But because of the low cell counts for individual categories this finding was not pursued further. The relevance of this difference is not altogether clear. If tax agents, who have been registered for ten years or more, were better judges of taxpayers' motives then the difference could suggest that there might be more to tax avoidance than high tax rates.

Specific questions relating to two of the three hypotheses in Table 2.3 were asked to see whether further insights into the causes of tax avoidance could be obtained. The answers given to these questions are summarised in Table 6.3.

In Chapter Two (2.4.11) Hulme was quoted as saying that self-employed taxpayers were likely to engage in tax avoidance through fear not greed - fear that when their income earning life was at an end they would be disadvantaged because they would not have the benefit of superannuation or retirement payments. He argued that more adequate tax concessions were presently required. This would allay their fears and consequently reduce their need to avoid tax. Hulme's views in this regard are supported by the answers to Question 2(c). Almost three-quarters of all tax agents agreed that self-employed taxpayers *did not*

TABLE 6.3

Responses to Specific Questions Concerning Two of the
Three Hypotheses about Tax Avoidance

1. Exchange Relationship Hypothesis

Q.2(c) Could you indicate the extent of your agreement/disagreement with the statement: "*Self-employed* taxpayers do not have adequate tax allowances for superannuation or retirement benefit contributions".

	<u>Number</u>	<u>%</u>
Strongly agree	321	55
Slightly agree	104	18
Neither agree nor disagree	46	8
Slightly disagree	66	12
Strongly disagree	43	7

Total	<u>580</u>	<u>100</u>
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Q.3(a) Could you indicate the extent of your approval for the system of paying tax by way of *provisional tax*.

Strongly approve	138	24
Slightly approve	179	31
Neither approve nor disapprove	68	12
Slightly disapprove	88	15
Strongly disapprove	107	18

Total	<u>580</u>	<u>100</u>
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2. Administrative Control Hypothesis

Q.1 Over the last ten years do you think that relations between the accountancy profession and the Australian Income Tax Office have improved or deteriorated?

Improved a great deal	68	12
Slightly improved	166	28
About the same	149	26
Slightly deteriorated	112	19
Deteriorated a great deal	63	11
Unable to answer	22	4

Total	<u>580</u>	<u>100</u>
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Q.4(a) How satisfied have you been with the *time* it takes the Income Tax Office to process annual returns?

Very satisfied	89	15
Somewhat satisfied	221	38
Neither satisfied nor dissatisfied	138	24
Somewhat dissatisfied	106	18
Very dissatisfied	26	5

Total	<u>580</u>	<u>100</u>
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TABLE 6.3 (continued)

Q.4(b) How satisfied have you been with the <i>time</i> it takes the Income Tax Office to make decisions on objections lodged against assessments?		
	<u>Number</u>	<u>%</u>
Very satisfied	29	5
Somewhat satisfied	89	15
Neither satisfied nor dissatisfied	86	15
Somewhat dissatisfied	201	35
Very dissatisfied	<u>175</u>	<u>30</u>
Total	<u>580</u>	<u>100</u>
Q.4(c) How satisfied have you been with the <i>time</i> it takes the Income Tax Office to deal with other correspondence on income tax matters?		
Very satisfied	25	4
Somewhat satisfied	124	21
Neither satisfied nor dissatisfied	103	18
Somewhat dissatisfied	200	35
Very dissatisfied	<u>128</u>	<u>22</u>
Total	<u>580</u>	<u>100</u>

have adequate tax allowances for superannuation or retirement benefit contributions. Of course it does not necessarily follow that these inadequate allowances have led to tax avoidance. What it does indicate is one specific matter which might influence taxpayers' perceptions about their terms of trade with the Government. [N.B. Similar support was not apparent for Hulme's other contention that the system of provisional tax contributed to tax avoidance.] If tax agents' opinions about that system of payment of tax reflected taxpayers' views, then only about one-third of taxpayers disapproved of it.

In relation to the administrative control hypothesis it seemed that two aspects of Tax Office procedures could have caused taxpayer dissatisfaction: namely, the time it took the Tax Office to process taxpayers' objections and the time it took the Tax Office to

process general correspondence from taxpayers. Only 20-25% of tax agents were satisfied with these activities compared with 55-65% who were dissatisfied. Strongest support from the questionnaire seemed to be for the simple proposition that taxpayers engaged in tax avoidance because they thought the amount of tax they paid in relation to their earnings was too high. This finding, if true, is not altogether surprising because it is often alleged that tax avoidance schemes are only available to high income earners and high income earners face high tax rates. It follows then that those who engage in tax avoidance are those who face high tax rates and such rates are bound to influence the taxpayers' decisions.

When the *pilot survey* results strongly supported the above proposition it was decided to add a new question to the full-scale survey to determine whether the strength of the suspected relationship between tax rates and tax avoidance could be confirmed. Such was question eight and the answers received are reproduced below:

Q.8 What do you think most professional people would most likely do when their income reaches the level where they have to pay the maximum marginal rate of tax (i.e. sixty cents in the dollar). They would:

	<u>Number</u>	<u>%</u>
Continue to work as before	10	2
Work <i>more</i> to counteract the effect of tax on their income	8	1
Limit their income by working <i>less</i>	47	8
Continue to earn, but look for ways of reducing their tax burdens by legal means	453	78
Continue to earn but seek ways of evading tax	57	10
Other (please specify)	5	1
Total	<u>580</u>	<u>100</u>
	===	===

Almost four-fifths of respondents claimed taxpayers would look for legal means to reduce tax once their incomes reached the maximum marginal rate of sixty cents in the dollar. Curiously the second most frequent answer was that taxpayers would seek illegal means of reducing their tax burdens. Those who argue that high tax rates affect individuals' incentive to work would receive no comfort from the findings from this question; at least in respect of professional persons on high incomes (*viz.* incomes greater than A\$35,788 or stg£21,000). The alternative that taxpayers would "limit their income by working less" was ranked behind avoidance and evasion even though it appeared high in the list of alternatives. Only eight per cent of tax agents thought that taxpayers would *most likely* limit their income by working less. More research needs to be done before any definite conclusions could be made about the effects of tax rates on incentive to work. But the findings here provide some food for thought.

6.5 THE FUTURE OF TAX AVOIDANCE IN AUSTRALIA

When tax agents were asked "what they thought would *most* often discourage taxpayers from undertaking tax avoidance schemes" a greater variety of influences seemed to be relevant. The answers to the relevant question were:

	<u>Number</u>	<u>%</u>
. The costs that have been associated with implementing those schemes	71	12
. The complexity of the scheme	108	19
. The expectation that benefits will only be temporary	64	11
. The belief that such schemes are morally wrong	58	10
. The possibility of protracted legal battles with the Tax Office	223	38
. Other (please specify)	<u>56</u>	<u>10</u>
Total	<u>580</u>	<u>100</u>

The possibility of protracted legal battles with the Tax Office was the single most important (38%) influence, however the costs associated with the scheme *and* complexity of the schemes were also frequently stated (31% when combined). This finding indicates that the Tax Office should, if they want to discourage taxpayers from undertaking tax avoidance schemes, challenge such schemes whenever they arise. This may well be their policy and might explain why this is the influence most frequently stated by tax agents as most likely to discourage tax avoidance. If so, this policy should continue, not only because it is the Tax Office's duty but also because it appears to be working. It is also possible that this policy might have few undesirable side effects. As revealed by question 6 *no* tax agent thought that taxpayers were mostly influenced to avoid tax because of the way they had been treated by the Tax Office. However, analysis of question 4 in the tax evasion survey showed that Tax Office administrative activities might be important (5.4.3).

Earlier in this chapter (6.2) it was mentioned that after the pilot study the legislature replaced its general anti-avoidance provision, s.260, with new legislation, Part IVA. As yet no case involving Part IVA has come before the courts and the likely effectiveness of this new legislation is not yet certain. Consequently, an attempt was made in this survey to determine what tax agents thought about it and whether they thought it would be effective in preventing tax avoidance. The relevant questions and responses are set out in Table 6.4. This table shows that a majority (59%) of tax agents approved of the new anti-avoidance legislation (Part IVA) and only 16% disapproved of it. This support existed even though a majority of tax agents thought the Commissioner might use the legislation against some family transactions

TABLE 6.4

Tax Agents' Opinions About Part IVA

1. The Likely Effectiveness of Part IVA

Q.2(e) Could you indicate the extent of your agreement with the following statement: "The new section 260 will probably be effective in preventing taxpayers from undertaking tax avoidance schemes".

	<u>Number</u>	<u>%</u>
Strongly agree	40	7
Slightly agree	229	40
Neither agree nor disagree	104	18
Slightly disagree	136	23
Strongly disagree	<u>71</u>	<u>12</u>
Total	<u>580</u>	<u>100</u>

2. The Likely Use of Part IVA

Q.2(f) Could you indicate the extent of your agreement with the following statement: "The Commissioner might use the new section 260 against some family transactions which previously he did not challenge".

Strongly agree	93	16
Slightly agree	284	49
Neither agree nor disagree	113	19
Slightly disagree	63	11
Strongly disagree	<u>27</u>	<u>5</u>
Total	<u>580</u>	<u>100</u>

3. Extent of Approval for Part IVA

Q.3(d) Could you indicate the extent of your approval for "The new section 260 (i.e. Part IVA) of the Act".

Strongly approve	138	24
Slightly approve	205	35
Neither approve nor disapprove	146	25
Slightly disapprove	51	9
Strongly disapprove	<u>40</u>	<u>7</u>
Total	<u>580</u>	<u>100</u>

which previously he did not challenge. Item 2 in Table 6.4 shows that 65% of tax agents agreed that this might happen. The surprising result was that concerning the likely effectiveness of Part IVA in preventing tax avoidance. Less than half (47%) of the respondents considered that Part IVA was likely to be effective. Some 35% thought that it would be ineffective and 18% were undecided. Given the publicity and aura surrounding the introduction of Part IVA, at this stage, one would have expected an overwhelming majority would have thought that the section would fulfil its role. At the very least one would have expected that if a majority doubted the likely effectiveness of the legislation they would be undecided rather than think it would be ineffective. The result on this question prompted further investigation. An attempt was then made to determine the influence, if any, of the three background characteristics. It was found that there was a significant relationship for two of the variables, *viz.* professional membership and whether tax agents were actively engaged in taxation practice. The significant results have been condensed to 2x2 contingency tables and are shown in Tables 6.5 and 6.6.

TABLE 6.5

Analysis of Professional Membership and Likely
Effectiveness of Part IVA

		<i>Professional Membership</i>		<i>Total</i>
		<i>Institute*</i> <i>No. (%)</i>	<i>Non-Institute</i> <i>No. (%)</i>	
Agreement on Likely Effectiveness of Part IVA	Agree	107 (55)	162 (42)	269
	Not Agree	86 (45)	225 (58)	311
	Total	193(100)	387(100)	580
=====				

* Institute of Chartered Accounts of Australia.

TABLE 6.6

Analysis of Engagement in Taxation Practice and Likely
Effectiveness of Part IVA

		<i>Engagement in Taxation Practice</i>		
		<i>Actively Engaged</i>	<i>Not Actively Engaged</i>	<i>Total</i>
		No. (%)	No. (%)	
Agreement on Likely Effectiveness of Part IVA	Agree	203 (50)	66 (38)	269
	Not Agree	201 (50)	110 (62)	311
	Total	404(100)	176(100)	580
		=====		

A chi-square value of 9.549 was obtained indicating a statistically significant difference of opinion [$p(x^2_{0.05}, 1 > 3.8415) = 0.05$], with members of the Institute of Chartered Accountants more likely to think the legislation would be effective. In fact a majority of Institute members (55%) thought that Part IVA would be effective whereas a minority of non-Institute members (42%) thought it would be effective. Why this should be so is difficult to know. Perhaps it has something to do with the Institute's own initiative to prevent tax avoidance. As question five tells the Institute issued an exposure draft entitled "Proposed Statement of Taxation Standards". These standards, if accepted, would become mandatory and failure by members to comply could result in investigation and disciplinary action. One of the proposed standards provided that "a member shall not promote, or assist in the promotion of any schemes or arrangements which have no commercial justification other than the avoidance of tax through exploitation of the revenue laws" (Para. 28). [N.B. In June 1982, some months after the survey was mailed, the proposed standards were, in essence, adopted as actual standards. Paragraph 28 of the draft became paragraph 25 but the wording of the proposed standard was unchanged.]

The other background characteristic related to opinions regarding the likely effectiveness of Part IVA was the extent of tax agents' engagement in taxation practice. A majority (50.2%) of those actively engaged in taxation practice agreed that Part IVA would be effective in preventing tax avoidance and of those who did not agree 17% were undecided. The remainder (33%) thought Part IVA would not be effective. For tax agents who were not actively engaged in tax practice only 38% thought that Part IVA would be effective, 20% were undecided and 42% did *not* think Part IVA would be effective. If it was reasonable to assume that those actively engaged in taxation practice would be better placed to comment on the likely effectiveness of Part IVA, then Part IVA just might be effective. However, if those not actively engaged in taxation practice are better placed to comment then Part IVA, like its predecessor, will fail in preventing tax avoidance.

Responses to question 2(a) are also relevant to discussion on the likely effectiveness of Part IVA. Question 2(a) asked whether tax agents agreed that "taxpayers were more willing to undertake tax avoidance schemes *now* than they were a year ago". The timing of the questionnaire requires emphasis before the answers to this question are given. Part IVA became operative on 27 May 1981 and the questionnaire was mailed approximately nine months *after* that date. In this time tax agents should have had time to consider and make judgments about the new legislation. Question 2(a) and the responses received are shown below. Again, somewhat surprisingly, a majority (52%) of tax agents agreed that taxpayers were more willing to engage in tax avoidance schemes 'now' (*viz.* March/April 1982) than they were 'a year ago'. That is, they were more willing to engage in tax avoidance schemes since Part IVA's enactment than before it! Only about one third of tax agents felt taxpayers

Q.2(a) Could you indicate the extent of your agreement/disagreement with the statement: "taxpayers are much more willing to undertake tax avoidance schemes now than they were a year ago".

	<u>Number</u>	<u>%</u>
Strongly agree	142	25
Slightly agree	159	27
Neither agree nor disagree	79	14
Slightly disagree	118	20
Strongly disagree	<u>82</u>	<u>14</u>
Total	580	100
	===	===

were less willing to engage in tax avoidance 'now'; the remainder, a mere 14%, were undecided. Perhaps it should be stressed that the question related to taxpayers' *willingness to undertake* tax avoidance schemes and not their actual behaviour. Still, the finding is surprising. Again, with this question the two background characteristics of professional membership and engagement in taxation practice gave significant results.⁷ In both cases a minority of Institute members (38%) and a minority of those actively engaged in taxation practice (47%) agreed that taxpayers were more willing to undertake tax avoidance now than they were a year ago. For non-Institute members and for tax agents not actively engaged in taxation practice, the respective numbers were 60% and 63%. The reason for the difference is debatable but the Government must be hoping that Institute members and those actively engaged in taxation practice are the better judges.

6.6 IMPLICATIONS FOR REFORM

One thing is clear: tax agents overwhelmingly supported the Government in its bid to stamp out tax avoidance. Responses to question 3(c) showed that 83% of tax agents approved of the Government's apparent determination to stamp out tax avoidance. The question and

answers were:

Q.3(c) Could you indicate the extent of your approval for "the Government's apparent determination to stamp out tax avoidance".

	<u>Number</u>	<u>%</u>
Strongly approve	360	62
Slightly approve	120	21
Neither approve nor disapprove	49	8
Slightly disapprove	19	3
Strongly disapprove	<u>32</u>	<u>6</u>
Total	<u>580</u>	<u>100</u>

A subsidiary purpose of the survey was to find out more about tax agents' views on various reform proposals; for instance, whether they thought the accountancy profession should be actively engaged in preventing tax avoidance. Question 2(b) asked this matter of tax agents and a mixed reaction was obtained..

Q.2(b) Could you indicate the extent of your agreement with the following statement: "The accountancy profession should be actively engaged in designing reforms to prevent tax avoidance".

	<u>Number</u>	<u>%</u>
Strongly agree	173	30
Slightly agree	109	19
Neither agree nor disagree	82	14
Slightly disagree	84	14
Strongly disagree	<u>132</u>	<u>23</u>
Total	<u>580</u>	<u>100</u>

Almost half (49%) of the tax agents agreed that the accountancy profession should be actively engaged in designing reforms but 37% disagreed. It was interesting to note that the two answers which received most responses were the two extremes, *viz.* strongly agree (30%) and strongly disagree (23%). Clearly this area is a contentious one.

Earlier in this chapter it was stated that the Institute of Chartered Accountants had already taken steps to help stamp out tax

avoidance. They issued an exposure draft entitled "Proposed Statement of Taxation Standards". These proposals now adopted as standards are mandatory and failure of members to comply might result in disciplinary action. Tax agents were reminded of the significance of such standards and asked what they thought of one of the then proposed standards.

Q.5 What is your opinion of the draft standard in paragraph 28 *viz.* "a member shall not promote, or assist in the promotion of any schemes or arrangements which have no commercial justification other than the avoidance of tax through the exploitation of the revenue laws".

	<u>Number</u>	<u>%</u>
Strongly approve	234	40
Slightly approve	119	21
Neither approve nor disapprove	55	9
Slightly disapprove	74	13
Strongly disapprove	<u>98</u>	<u>17</u>
Total	580	100
	===	===

A majority of tax agents (61%) approved of para. 28 in the draft standard and only 30% disapproved of it, the other 9% being undecided. Additional tests on the background characteristics suggested that they were not influential in determining tax agents' opinions. As the proposed standard would only apply to Institute members it could have been expected that professional membership might have influenced answers. But this was not the case. A majority of both Institute members (62%) and non-Institute members (60%) approved of the proposed standard. What was surprising was that the exposure draft, issued in September 1980, had not become a standard at the time the survey was undertaken (March 1982). Nor had the other professional accounting body (The Australian Society of Accountants) taken the Institute's lead and issued a similar draft. Subsequently, in June 1982, both professional accounting bodies issued the same taxation standards (e.g. APS 6 for the Institute of Chartered Accountants in Australia). These standards

differed in some respects from the draft standards but paragraph 28 of the draft was unchanged except that it became paragraph 25. The actual standards regarding "Tax Arrangements" are set out hereunder:

Tax Arrangements

23. A member has a duty to use professional knowledge to enable a client to obtain the most favourable tax position consistent with the desire of the client and the requirements of full disclosure and of the law generally.
24. The decision to enter into any tax arrangement must always be that of the client and a member must ensure that the client is fully informed of the details of the arrangement and its current and future ramifications including the risks and uncertainties, particularly in relation to possible changes in the law.
25. A member shall not associate himself with any arrangement which involves documents or accounting entries that are intended to misrepresent the true nature of a transaction or which depends upon lack of disclosure for its effectiveness.
26. A member shall not promote, or assist in the promotion of, any schemes or arrangements which have no commercial justification other than the avoidance of tax through exploitation of the revenue laws.
27. The prohibition that a member shall not promote schemes or arrangements does not preclude a member from advising his clients on such matters. The prohibition is particularly directed at the marketing of artificial and contrived schemes to the general public.
28. Without limiting the generality of paragraph 29 hereof a member shall not have any financial interest in any business organisation (whether incorporated or otherwise) which promotes tax schemes or arrangements, and a member shall not render any professional services to any such business organisation in which any near relative or dependant of the member has any financial interest.

[*Statement of Taxation Standards*, Institute of Chartered Accountants in Australia, June 1982.]

Combining the answers to questions 2(b) and 5 it seemed that tax agents did not strongly support the view that the accounting profession should be actively engaged in reforms to prevent tax avoidance but if

the profession did take action in this regard it would, nevertheless, receive the support of a majority of members.

In Chapter Four it was shown that two ways taxpayers have avoided tax was to split income with others (4.2) or to have converted potential income receipts into capital (4.3). Often the means adopted to achieve these ends were simple and were widely used. They did not tend to be blatant, artificial or contrived. However, they resulted in tax avoidance and the opportunities were not available to all taxpayers. The Government has been aware of these forms of tax avoidance but has not taken action to prevent them. The writer was curious to know why; to know what tax agents thought about this type of avoidance; and to know what they thought about possible reforms to prevent them. But because this was only a minor purpose of the survey only two questions were asked. The first question sought tax agents' views on the use of trusts to carry on family businesses. [N.B. Trusts seemed to be the most efficient way of splitting income.⁸]

Q.3(b) Could you indicate the extent of your approval for "the use of trusts to carry on family businesses".

	<u>Number</u>	<u>%</u>
Strongly approve	221	38
Slightly approve	121	21
Neither approve nor disapprove	85	15
Slightly disapprove	62	11
Strongly disapprove	<u>90</u>	<u>15</u>
Total	580	100
	===	===

Question 3(b) revealed that 59% of tax agents approved of the use of family trusts to carry on family businesses and only 26% of tax agents disapproved of their use. Yet responses to question 3(c) revealed overwhelming approval (83%) for the Government's apparent determination to prevent tax avoidance. Clearly use of trusts was *not* regarded as one of the types of tax avoidance which ought to be stamped out.⁹

The second question related to one possible reform to prevent tax avoidance resulting from the conversion of potential income receipts into capital receipts. Question 2(d) asked:

Q.2(d) Could you indicate the extent of your agreement with the following statement: "if tax avoidance can be prevented by the introduction of a capital gains tax then such a tax should be introduced".

	<u>Number</u>	<u>%</u>
Strongly agree	94	16
Slightly agree	93	16
Neither agree nor disagree	40	7
Slightly disagree	53	9
Strongly disagree	<u>300</u>	<u>52</u>
Total	580	100
	===	===

Only about one-third of tax agents agreed that a capital gains tax should be introduced even if it could prevent tax avoidance. Significantly, a majority (52%) strongly disagreed that such a tax should be introduced even if it would prevent tax avoidance. Two points need to be emphasised: firstly, that tax avoidance was specifically defined for respondents to confine their attention to those schemes which were outside the spirit of the law; secondly, as mentioned with the previous question [3(b)] tax agents overwhelmingly supported the Government's apparent determination to stamp out tax avoidance. One obvious conclusion to draw from this is that a capital gains tax would receive little support from the profession if such a tax was introduced. Tax agents would, presumably, strongly urge the Government to look for alternative means of preventing tax avoidance. However, without such a tax there would always appear to be scope for tax avoidance by converting potential income receipts into capital receipts.

6.7 COMMENTS ABOUT TAX AVOIDANCE

Free space was provided at the end of the questionnaire for tax agents to write comments. About one-quarter of respondents (163/580) included comments with their answers to the questionnaire. Although it is not possible to list or even categorise all comments made, they provide valuable further information and some account of the comments is given in the following sections.

6.7.1 Comments about the Causes of Tax Avoidance

By far the most frequent comment was that tax rates were too high and that this caused much of the avoidance. Typical comments included:

There is a very strong feeling within the community that tax rates are too high and are stifling incentive, hence the attraction of tax schemes.

[N.B. It should be emphasised that although this comment was made it did not agree with the findings of question eight (6.4) for professional persons.]

Most people with whom I have discussed this matter agree that should a more equitable tax scale be introduced incentive to work would return and the tax avoidance industry would slow down.

The Government will never stamp out tax minimisation while tax rates are so high.

These comments add force to the primary finding from question six, *viz.* that taxpayers most wanted to engage in tax avoidance because they thought the amount of tax they had to pay in relation to the amount they had earned was too high. Apart from tax rates other aspects of the tax system came under attack including what agents saw as the double taxation of company profits (i.e. the taxation of company profits and the taxation of distributions from them), the abolition of deductions in respect of dependants and certain concessional expenditure and the restriction of income equalisation deposits to primary producers. But,

apart from tax rates, the aspects of the tax system which provoked the most comment were "provisional tax" and "income splitting". For instance:

Provisional tax is cruel on a small businessman who has been successful in the first year and needs that money to invest in his business.

and

I think everyone should be able to split their income with their wife for equity reasons. Wage and salary earners are worst done by.

Many saw the tax laws as being so complex and being in such a mess that "a complete rewrite was required". These typical comments strongly support the "exchange relation" hypothesis as a cause of tax avoidance in Australia and, in particular, *high tax rates are the most significant element* of this though other aspects of the tax system are also important.

Of the other two hypotheses - the "social orientation" hypothesis and the "administrative control" hypothesis - only the latter received any comment. However, it is not clear whether the comments received about Tax Office administration reflected tax agents' own views about their working relationship with the Tax Office or views of their clients. Some tax agents, though a minority, said that relations with the Tax Office had improved. They cited things such as establishment of regional offices, establishment of the tax agents liaison centre and direct telephone communications with assessors as factors which have helped. However, the majority of comments about the Tax Office were unfavourable. Among specific comments were:

The Department is obsessed with raising revenue, not applying the laws of the Act.

I believe the problems associated with the Taxation Department to be one of inconsistency in that, depending upon the assessor, you may receive different results. This indicates to me a lack of instruction within the Department.

Quantity and quality of Tax Office staff is disappointing.

The Taxation Department appears to be 'bloody minded' at times against the small taxpayer who cannot fight back.

... the Department is hounding the 95% of reasonable taxpayers instead of really persecuting (and prosecuting) the 5% who use highly complex and artificial tax avoidance schemes.

Tax agents also gave reasons for the Tax Office's approach over recent years. Some suggested it was a result of direct pressure from the Government. Others, including one tax agent who was employed for forty years by the Tax Office "believed that the Tax Office has 'got tough' as a result of increased tax avoidance".

Some support seemed to exist for the "administrative control" hypothesis because sooner or later tax agents' experiences in dealing with the Tax Office would filter on to their clients and affect their clients' behaviour. In any event, it seemed that there was scope to improve relations between tax agents and the Tax Office and the starting point could be a change of attitude by the Tax Office in respect of annual income tax assessments.

6.7.2 Comments on How to Best Discourage Tax Avoidance

Only a few comments were received about things which might discourage tax avoidance and these comments supported the findings of question seven, *viz.* that the possibility of protracted legal battles with the Tax Office was the influence most likely to discourage tax avoidance. Relevant comments included:

One of the major factors discouraging tax avoidance is the abuse by the Tax Office of its powers re the imposition of penalties and claims for deductions.

and

The Tax Office tactic of delay combined with punitive legislation has discouraged new starters (for tax avoidance).

The impact of the new anti-avoidance legislation (Part IVA) seemed uncertain. This confirmed the answers given to question 2(e) where less than half of those responding thought it would be effective. The following opposing comments were made by several agents:

Because of the new Part IVA there is now a definite reluctance by most people to enter 'contrived' schemes

and

Being presently assisting clients with schemes ...
I seriously doubt Part IVA's dynamic impact. It may be a paper tiger.

6.7.3 Comments about Reforms to Prevent Tax Avoidance

Quite a variety of tax reforms were suggested by tax agents, some of which were simply to improve the tax system but others were specifically directed at reducing tax avoidance. None of the reforms suggested was new but the degree of support for two particular reforms was surprising. The two reforms were a flat rate tax and the replacement of income tax with some form of indirect tax:

I firmly believe that if we adopted an equitable tax system whereby everyone paid a flat rate of tax (of say 25%) there would be no need to avoid tax.

I believe that tax avoidance would be wiped out by the introduction of a flat rate tax.

I would like to see indirect taxation completely replace income tax because it would ... (reduce avoidance) ... catch the 'cash economy' ...

Other comments were made about reforms to prevent avoidance. These included the introduction of a capital gains tax, the reduction of tax evasion and the curbing of Government spending:

Originally I was against a capital gains tax - but no longer - I believe the introduction of this tax would go a long way towards putting the Australian tax system on a more equitable scale.

It is my belief that if tax evasion were to be eliminated ... there would be no need to avoid tax ...

The more money a Government collects - the more it will spend (like all of us!). It is the expenditure side that needs reform.

6.7.4 General Comments about Tax Avoidance

Quite a diversity of general comments were made and only those repeated on several occasions are summarised here. The main comment seemed to be about tax agents' obligations and without exception tax agents saw their first duty to their clients:

An accountant or tax agent's job is to legally advise his clients how to pay the least amount of tax. For accountants not to advise their clients in this manner is negligence on their behalf.

However, in fulfilling this perceived obligation tax agents and accountants were seen to be placed in an awkward position *vis a vis* the Tax Office:

The accountancy profession is often caught in a cleft stick. To satisfy the requirements of its clients the profession must advise on ways of reducing tax liability. By so doing the accountants' role is therefore unfavourably regarded by the Government and the Taxation Department.

Other comments were made and these:

- (i) reaffirmed support of the so-called 'Westminster Principle' that every man is entitled to organise his affairs so as to reduce his tax burden to the legal minimum;

- (ii) suggested which types of taxpayers went in for tax avoidance, *viz.* high income earners and 'mid-Europeans'; and
- (iii) suggested, or questioned, possible effects of tax avoidance.

For instance, the comments included:

The Government continually publicises the amount 'lost' through tax avoidance - but lost to whom? The majority of tax minimisation monies are retained in businesses as essential working capital, to maintain and create jobs ...

As more loopholes are being blocked people are now turning to evasion, especially non-professionals.

The current legislation discriminates against wage and salary earners. This has led to considerable inequity. Unless the imbalance of the taxation system is overcome the consequences will be escalating wage demands and a growing incidence of tax evasion.

It was suggested that avoidance by some could lead to evasion by others. Yet earlier it was suggested that avoidance was, in some cases, brought on by evasions by others. If both perceived relationships are true then it means there is a vicious cycle with avoidance fuelling evasion and evasion fuelling avoidance. How this started is unimportant. What is important is how to stop it before it gets out of hand.

6.8 SUMMARY

The single most important cause of tax avoidance, according to tax agents, was high rates of tax. Some 74% of tax agents gave high rates of tax as the reason they thought would most influence taxpayers to engage in tax avoidance (see 6.4). The maximum marginal rate of tax, in Australia, is sixty percent and it was, it seemed, taxpayers facing this rate who went in for tax avoidance. Taxpayers whose taxable income exceeds A\$35,788 (i.e. approximately stg£21,000) paid tax at this rate

on each dollar of taxable income which exceeded A\$35,788. For the year in question approximately six or seven per cent of taxpayers faced this rate.¹⁰ 'Paper schemes' often require complex legal documents to be drawn up and need accompanying opinions from legal experts specialising in revenue law. These cost money. Added to this are the fees of those who market the schemes and any necessary minimum involvement. (Minimum investment of A\$20,000, or £12,000 stg, is not unusual.) Avoidance, though potentially open to all, has probably been practised by the few who have been the high income earners who face high marginal tax rates. Avoidance and high tax rates can be likened to the chicken and the egg - they go together but which came first is difficult to know.

In terms of the three hypotheses about tax avoidance the "exchange relationship" received, by far, the strongest support from answers given to the survey. There was also weaker support for the "administrative control" hypothesis though much of the criticism directed against the Tax Office administration practices may indicate other problems and may have resulted from Tax Office reaction to tax avoidance. Specific questions relating to the exchange relationship hypothesis suggested that perceptions of high tax rates by self-employed taxpayers might be reduced if those taxpayers were given more adequate tax allowance for superannuation or retirement benefit contributions (see Question 2(c) in Table 6.3).

According to tax agents the thing most likely to discourage taxpayers from undertaking tax avoidance schemes was the possibility of protracted legal battles with the Tax Office. This answer was given by 38% of respondents whereas the second most significant answer, "the complexity of the avoidance scheme", was given by 18% of respondents (see 6.5). The message for the Tax Office was clear: if you want to

continue to discourage tax avoidance then you must continue to contest tax avoidance schemes as you become aware of them.

Tax agents believed that their first duty was to their clients and it was the Government's responsibility to make tax laws and prevent tax avoidance. Tax agents approved of the Government's apparent determination to stamp out tax avoidance. Only 9% of respondents disapproved of the Government's determination whereas 83% approved (see question 3(c) in 6.6). Unfortunately, for the Government, there was a large proportion of tax agents who believed the recent anti-avoidance legislation would not be effective in preventing tax avoidance. Some felt that as long as tax rates were high avoidance would always exist. Only 47% of respondents agreed that the new anti-avoidance provisions, Part IVA, would be effective in preventing taxpayers from undertaking tax avoidance - 35% disagreed and 18% were unsure (see question 2(e) in 6.5).

Of the reforms suggested those receiving greatest support were introduction of a capital gains tax, provisions to allow all taxpayers to split income and the introduction of a flat rate scale for income tax. But, it should be emphasised that capital gains tax was not favoured by the majority of tax agents *even if* it would reduce avoidance (see question 2(d) in 6.6). Quite a number believed we should start all over again and if this was to be the case then other taxes, particularly indirect taxes, should be considered.

FOOTNOTES TO CHAPTER SIX

1. The formula $n \geq \frac{N}{1+4\pi\lambda^2(N-1)}$ was used.
2. *List of Registered Tax Agents as at 30 June 1981*, Commonwealth of Australia, No.P11, Canberra 1981.
3. The pilot was split into two groups of fifty and responses received were:

*Effect of an Incentive on Response Rates
Re Pilot Survey on Tax Avoidance*

	No. of Responses
Incentive	34
No Incentive	<u>24</u>
	<u>58</u>

As a percentage of effective mailings the response rates were: incentive 72%, no incentive 55%. When the null hypothesis was set up as:

H_0 : the proportions are the same $Q1 = Q2$

H_1 : $Q2 \neq Q1$

it was shown that there was a statistically significant difference between these two proportions. For: $P_z 1.645 = 0.05$ it was found that $z = 1.7645$.

4. Effective Response Rate = $\frac{\text{Usable Responses}}{\text{Effective Mailings}} \times \frac{100}{1}$

$$= \frac{580}{970} \times \frac{100}{1}$$

$$= 60\%.$$
5. A.N. Oppenheim, *Questionnaire Design and Attitude Management*, (London: Heinemann Educational Books, 1979) states late respondents and non-respondents are roughly similar - p.34.
6. See earlier in this Chapter at 6.2.
7. For professional membership $\chi^2 = 48.844$ when $p(\chi^2 0.05, 12 > 21.026)$ and for active engagement in taxation practice $\chi^2 = 29.344$ when $p(\chi^2 0.05, 4 > 9.4877)$.
8. See Chapter Four at p.174.
9. This result was to be expected because of the way tax avoidance, for purposes of the survey, was defined.
10. Source: Table 1, *Taxation Statistics 1979-80*, Parliamentary Paper No.99/1981, Canberra: Commonwealth Government Printer, 1981.

CHAPTER SEVEN

REFORMS TO LIMIT TAX EVASION AND TAX AVOIDANCE

7.1 REFORMS TO REDUCE TAXPAYERS' DESIRE TO EVADE AND AVOID TAX

Comments made in both the evasion and avoidance surveys suggested that some taxpayers might undertake one of these activities because others undertook the other. For example, wage and salary earners might evade tax on weekend earnings because they believed high income earners used legal devices to avoid tax on their income. Thus proposals which reduced avoidance might have implications for evasion, and *vice versa*. In *this* chapter an attempt is made to separate those reforms which might limit the scope for evasion from those reforms which might limit the scope for avoidance. But first some comments are made about reforms to reduce taxpayers' *desire* to evade or avoid tax.

According to tax agents the main reason why taxpayers go in for avoidance is that they think tax rates are too high. In fact, 84% of tax agents believed this was the most likely reason. According to the evasion survey more than eighty percent of respondents believed tax rates were too high. These perceptions might be ill-informed but they remain the basis of taxpayers' opinions. It seems, therefore, that while taxpayers *think* tax rates are too high they will seek to avoid or evade tax. One simple means of reducing evasion and avoidance could be to reduce tax rates, perhaps more so with avoidance than evasion, particularly at the upper end of the tax scale. It is often alleged that it is high income earners that engage in tax avoidance and while the maximum marginal rate is sixty per cent it is easy to understand why

tax rates are thought to be so influential. Some attempt should be made to reduce the maximum marginal rate or to ensure that it only applies to very high incomes. At present it applies to taxable income in excess of A\$35,788 (i.e., approx. £20,000 stg). This level should be raised substantially, at least to A\$50,000 (i.e., approx. £30,000 stg) perhaps higher.

Consideration could be given to the United States proposal (s.1348) which has been introduced into the tax code to limit the maximum marginal rate of tax on earned income to fifty percent. Given the responses to question 8 in the tax avoidance survey the proposal merits serious attention. Answers given to that question showed that 88% of respondents believed that professional people would most likely look for ways of avoiding or evading tax when their marginal rate of tax reached the present maximum of sixty cents in the dollar. Only 8% believed that they would limit their income by working less. If tax rates cannot be reduced immediately, then something needs to be done to convince taxpayers that the present level of taxes is justified. Something should also be done to reduce the perceived waste in Government spending. Annual tax returns could contain simple graphical representations of the distribution of government spending. Media releases throughout the year could ensure that taxpayers are fully aware of Tax Office enforcement activities and key areas of Government spending. Programmes for secondary school students could also be initiated so that an appreciation, at an early age, of Government intervention in economic activity could be obtained. Unless taxpayers feel they are getting value for their tax dollars there will always be discontent with Government spending.

Other suggested reforms to reduce evasion and avoidance follow. These reforms should increase government revenue and should, at the same time, improve equity between taxpayers. Whether the suggested reforms are adopted is a matter for the legislature which should take into account these and other benefits as well as the costs of the proposed measures. No attempt is made here to specify other objectives or possible costs. At first sight it would seem the costs are likely to be small in relation to the benefits obtained. Further, it is not suggested that the proposed reforms, if adopted, would eliminate the need for future reform. Reform is likely to be an ongoing process. However, the proposed reforms, because they seek to remedy systemic weaknesses, are likely to minimise the need for future reforms.

In proposing reforms to the income tax system it is implied that this system will be retained as the major source of Commonwealth revenue. This assumption rests on the fact that, historically, income tax has been the major source of Commonwealth revenue and that tax reforms have been relatively minor, perhaps because small changes are more feasible administratively and more stable politically. One alternative which has *not* been considered as a means of reducing income tax evasion is a shift to indirect taxes as the major source of revenue.

Taxpayers ought to be given advance warning of any major changes in policies towards tax evasion. Consideration could also be given to a "tax amnesty" operating for a limited time before new, and hopefully tougher, measures were introduced to prevent evasion. It should also be emphasised that many of the reform proposals are offered without their being fully explored. Some are thesis topics in themselves, e.g. capital gains tax and flat rate tax. The overriding criterion used in selecting proposed reforms is their ability to limit tax evasion or

avoidance. Compatibility of the proposed reforms with other criteria cannot therefore be assumed.

7.2 REFORMS TO REDUCE TAX EVASION

7.2.1 Reform of Tax Collection Procedures

If opportunities for evasion are to be limited tax should, as far as possible, be deducted at source; that is, where the income first emerges. This principle should be adhered to even though the recipient does not ultimately enjoy the income but holds it or pays it over to another person who is the beneficial owner. Empirical research by the Internal Revenue Service in the United States confirmed that voluntary reporting was highest where tax is deducted at source.¹ Where it is not practical to deduct tax at source, compliance should still be encouraged by requiring some form of information reports to be made to revenue authorities. In 1976 the highest areas of non-compliance by United States' taxpayers were payments to sub-contractors. A sub-committee of the United States Senate was told that almost half of the 50,000 independent contractors had not reported any earnings for income tax purposes.² If this is the case in Australia then overseas experience in preventing evasion in this area should be reviewed. For instance, since 1975, in the United Kingdom where a contractor makes a payment to a sub-contractor, payment is required to be deducted at source on the "labour content" of the payment. In addition contractors must supply details of all payments to the revenue authorities and sub-contractors must be registered otherwise payments to them are not deductible for tax purposes. Sub-contractors who are registered with the Board of Inland Revenue are issued with a card on which appears the sub-contractor's

name, national insurance number, photograph and signature. Whether all these requirements are appropriate in the Australian context is difficult to determine. At least it should be possible to require instalments of tax either at a low rate, say 20% of gross payments made to sub-contractors or say, 35% of the labour content of the payments. Instalments should also be required from payments to entertainers, sportsmen, free lance writers and others who derive income essentially from the supply of their labour, skill or expertise. The definition of "wages and salaries" in s.221A(1) of the Act needs to be extended to ensure that it applies in these cases irrespective of whether an employer/employee relationship exists. Instalments of tax should also be required in respect of all taxable fringe benefits. Schedules should be devised listing cash equivalents where benefits are given otherwise than in cash. Such a system has worked in the United Kingdom for certain fringe benefits since 1978.³

Collection practices in the United Kingdom also indicate that it is administratively possible to collect instalments of tax from a variety of other types of income including interest,⁴ dividends, royalties, annuities and mining rents. Trust income and partnership income could also be taxed at source rather than in the hands of the recipients. Extension of the principle of deduction of tax at source would reduce the opportunities for evasion and may also encourage taxpayers to file returns, because instalment systems usually result in (slight) overtaxation. Taxpayers would therefore be encouraged to lodge their returns promptly to obtain a refund of the overpaid tax. Overtaxation has the added advantage that it reduces the psychological pain of paying tax. On the other hand overtaxation has its critics because it tends to be regressive; it may penalise the sick, those out

of work, students or housewives who work on a temporary basis. It may also increase administrative costs.

Extension of the principle of deduction of tax at source will also improve equity between taxpayers by bringing tax payments into closer temporal alignment. Where it is not possible to extend this principle, the system of provisional tax, which presently exists in Australia for taxpayers not paying tax by instalments, should be changed. Payment of any surplus/deficiency on an assessment should be made immediately with provisional tax being paid by way of instalments. An instalment system has been introduced for companies and there seems to be no good reason why it ought not be introduced for those paying tax by way of provisional tax.

7.2.2 Reform of Record Keeping Requirements

One of the projects carried out by the United States Internal Revenue Service in 1979 showed that improved bookkeeping requirements and training in bookkeeping can greatly improve compliance.⁵ The inadequacies of the bookkeeping requirements in the *Income Tax Assessment Act* 1936 have already been explained (3.4) and it must be conceded that they contribute to the extent of tax evasion in Australia. Small scale traders in particular need more guidance than given by phrases such as that contained in s.262A, viz. "every person shall keep sufficient records in the English language ... to enable his assessable income and allowable deductions to be readily ascertained ..." Specific instructions on the books of account that should be kept and the accounting procedures that should be followed must be given - either in the Act or in the Regulations. At the very least a series of questions should be asked to determine the adequacy of taxpayers' records and the

appropriateness of the accounting procedures followed. If the Taxation Office is unable to specify what records ought to be kept then it should enlist the help of the accountancy profession. Investigations by the United States Internal Revenue Service showed that bookkeeping was worst in areas referred to as "informal activities". These were characterised by one man operations and involved poor record keeping and weak internal control. In these areas taxpayers could be advised what records to keep and of how to keep them. If this proved to be unsatisfactory then additional measures might be required. United States experience suggests that some form of registration might be required, particularly where the business is labour intensive. For example, in areas such as child care, domestic services, private tutoring, building trades and servicing, cleaning and motor vehicle servicing.

Improved knowledge of income tax laws also improves compliance. Again, United States' experience could be viewed. For some years a "Taxpayers' Services Program" has operated to assist taxpayers in this regard. Activities range from simplification of tax forms and guides, conducting courses in record-keeping and providing telephone and over the counter enquiry services. The programme goes as far as actually completing income tax returns for certain taxpayers provided, of course, they supply the necessary information.⁶

7.2.3 Reform of Resources Used to Detect Evasion

Revenue authorities have persistently maintained that improving the quantity and quality of resources used to detect evasion is the only way of having any significant impact on the level of evasion. In the United States computerisation has permitted much of the improvement in quality control. As computerisation of the Australian tax system is

in its infancy a review of developments in the United States practice should assist in improving the quality of resources used to detect evasion of income tax in Australia. Of particular interest is the development of audit techniques in the U.S.A. According to official estimates only 2% of individual tax returns in 1979 were subject to audit⁷ yet the audit programme is regarded as highly successful. Nearly 80% of returns selected required change and for every dollar spent on audits about five were raised in assessments. Even so, it was considered that the major payoff from the audit programme came from secondary benefits, e.g. compliance from associates of those audited or from those aware of the audit programme's success.⁸ The main reason the audit programme was not more extensive was because, at the end of the year, there were still 700,000 uncompleted investigations. The success of this audit programme came from the methods used for selection of taxpayers for audit. Sampling techniques are used to generate coefficients for the probability of detecting evasion.⁹ The annual sample of returns subject to audit has the greatest probability of detecting evasion. Not all of the criteria which are used to generate these coefficients, nor the relative importance of each criterion, are publicly known but they include income level, nature of the income and whether income is subject to tax instalments. Taxpayers with multiple selection criteria have a greater chance of being selected for audit.

No *evidence* is available to suggest that the Australian Taxation Office is using discriminant analysis or any other predictive models to select taxpayers for audit. It would seem to be an efficient use of resources and a logical extension of present efforts to computerise the tax system. The Australian Tax Office should seek to determine characteristics of evaders and non-evaders. This could be done in the

same way as the United States Internal Revenue Service developed its techniques. First, a random sample of taxpayers should be drawn and these should be thoroughly investigated. Compliance profiles of different classes of taxpayers should then be determined by using discriminant analysis. This information should then be used to select an annual sample of taxpayers for investigation.

The United States Internal Revenue Services' 1979 Interim Report also suggested that it was necessary to develop "follow-up" programmes for taxpayers who had been convicted for tax offences. Statistics indicated that, after conviction for tax evasion and as time elapsed taxpayers tended to go back to their old habits. In fact, after four years almost 40% of taxpayers, who had been convicted in 1972 for not lodging an income tax return, failed to lodge a return in 1976. In addition it was found that only about 50% of taxpayers sentenced in 1972 were completely compliant over the next four years.¹⁰ This apparent potential for recidivism may indicate some systemic weakness as well as the need for monitoring the compliance of taxpayers after initial conviction.

The Planning Model Study also included a report which showed other administrative techniques which detect evasion. For example -

- (i) The Catfish Project showed that where homogeneous groups exist ratio analysis can be developed for determining what income should be produced from a given level of inputs and what proportion of that income should be used on different types of expenses. This idea is not new. Groves¹¹ developed various means of verifying expense claims for two types of income over twenty years earlier.
- (ii) The Carbon County Project indicated that often associates of non-compliant taxpayers had bad records of compliance and special attention might profitably be paid to this group.

(iii) Generally, use of regional offices was an effective administrative starting point in detecting tax evasion in regional areas. Canada and the United Kingdom also make greater use of regional offices. Recently (1979) Canada recognised the potential of regional administration when, as part of a threefold campaign against tax evasion, the Department of National Revenue put four assistant deputy commissioners into the field to strengthen their regional administration.

New methods of detecting evasion might require more powers for revenue authorities to obtain information. If so, consideration should be given to s.20A-C of the *Taxation Management Act* (UK) 1970. Section 20A permits an Inspector of Taxes to require tax accountants convicted of particular offences after 1 July 1976, to deliver to him documents in their possession which relate to any of his clients' affairs, whereas s.20C establishes a procedure by which a tax officer can enter, by force if necessary, and search premises where there are reasonable grounds for suspecting fraud.¹² This section also permits officers to seize and remove anything that they reasonably believe might be required as evidence in subsequent proceedings.

The main problem of the Australian Tax Office at present is inadequate numbers of staff. Not only has this restricted the amount of enforcement activities but also it has affected morale among employees in the Tax Office. According to one newspaper report, taxation officers conducted work-to-regulations campaigns during the peak assessment period in 1981 as a protest against staff shortages.¹³ (N.B. These campaigns intensified during 1982. Morale has further deteriorated as a result of extensive publicity given to tax evasion activities known as "bottom of the harbour schemes", which have gone unchecked since 1972 and have resulted in massive tax evasion.)

7.2.4 Reform of Penalties for Tax Evasion

The review of empirical research (2.4) indicated that taxpayers' perceptions of the severity of penalties might be just as important as the absolute level of those penalties. Recommendations designed to improve the structure of penalties should therefore relate to both of these influences. Judging from responses to question 5 in the tax evasion survey, taxpayers have little knowledge of the penalties that can be imposed for evading tax. Question 5 and the responses received are given below:

Question 5

Some people have a good idea of the *penalties* for cheating on their income tax but others have no idea. If a friend asked what the penalties were, what would you say?

	<i>Evaders</i>	<i>Non-Evaders</i>
I have ... almost no idea	9%	19%
very little idea	12	25
some idea	24	31
a fairly good idea	29	20
a very good idea	26	5
	<u>100%</u>	<u>100%</u>
	=====	=====

Neither group seemed to have a significant knowledge of the penalties for evasion. Barely half the evaders (55%) had a "fairly good idea" or a "very good idea" and only 25% of non-evaders had the same knowledge. Perhaps the evader group exhibited a better knowledge because they had been convicted and fined for evading tax and would be painfully aware of the penalties. However, even so, some 21% still had "very little" or "almost no idea". For the non-evader group 44% admitted to having "very little" or "almost no idea" of the penalties. Clearly something needs to be done about taxpayers' knowledge of or perceptions of the penalties if they are to influence taxpayers' behaviour. Taxpayers' perceptions of penalties could be enhanced by

greater publicity. This could be achieved in several ways. Annual returns and information leaflets could contain a summary of the most common offences and the penalties for those offences. Taxpayers could also be reminded by media releases during the year. Media releases could also include details of anti-evasion campaigns or successful prosecutions. Where funds to encourage compliance are limited then a formula could be worked out to balance resources spent on actual enforcement activities and resources spent on publicity. If compliance is a behavioural problem, tax reforms to reduce evasion must take taxpayers' psychology into account. Not only should penalties exist, they must be seen to exist.

Penalties should also be commensurate with the offence. In the United States and Canada penalties are fixed as a percentage of tax evaded and for more serious cases of evasion, for example where there has been a deliberate attempt to defraud, the percentage is higher than the one usually applicable.¹⁴ Where penalties are expressed as fixed percentages they are imposed with *uniformity*. Penalties expressed in fixed dollar amounts, like most of those imposed in Australia, lose their real value over time unless they are updated to take account of the effects of inflation.

More work needs to be done on the nature and effect of penalties, for as Silberman¹⁵ suggests they have many aspects which require consideration. He found that in some cases penalties may have no effect; for example, on those who are already morally committed to conformity or on those who perceive the threat of punishment as inconsequential. Further, Silberman states "studies on the effects of certainty and severity of punishment on crime rates consistently describe weak, although significant, negative associations between certainty of

punishment and crime rates, and no association between severity of punishment and crime rates, except for homicide.¹⁶ This does not mean that tax penalties are unimportant; rather, it emphasises a threshold below which they are likely to be ineffective and above which they will have effect particularly if it is fairly certain they will be imposed on taxpayers who evade tax. It also emphasises the relationship between probability of detection and level of penalties. Silberman's work offers two avenues for further research: first, finding the thresholds for particular tax offences; and second, finding alternative means of improving compliance. The practices of the United Kingdom Board of Inland Revenue could usefully be studied. The Board has attempted to avoid confrontation with taxpayers; very few offences result in criminal prosecution¹⁷ and civil prosecutions are reserved for only the more serious cases of fraud or evasion. Generally alleged evaders are encouraged to co-operate in exchange for lower pecuniary penalties.

If the structure of penalties is not to be changed then, at least, more publicity should be given to tax enforcement activities. Non-evaders will be comforted that offenders are being caught and would-be evaders might be discouraged from evading tax. A starting point might be the establishment of a Public Relations Department within the Taxation Office. Its function, among other things, would include making nationwide press releases about penalties and enforcement activities.

Consideration could also be given to a system of "negative penalties" or rewards. For instance, both the United Kingdom and the United States offer rewards for information which leads to the prosecution of tax evaders. In the United Kingdom, s.32 of the *Inland Regulation Act* 1890, though little used, allows the Commissioners to pay amounts to persons who inform the Board of any offence against the Act or who assist in the

recovery of any fine or penalty. Unfortunately, the maximum which can be paid without the consent of the Treasury, has been left at its original (1890) level of £50. The United States practice of paying informers a fixed percentage (10%) of the "delinquent tax" seems to be a superior method of reward as it offers an incentive geared to the severity of the offence disclosed. Another aspect of United States' law which deserves mention is the remission of possible criminal proceedings against taxpayers who make a voluntary disclosure of their evasions. Back taxes must be paid in full together with the penalties, but the knowledge that criminal proceedings will not be taken against them acts as the incentive to declare their past evasions. Similarly, s.102 of the *Tax Management Act* (UK) 1970 allows Inspectors of Taxes to accept voluntary disclosures of evasions from taxpayers, to mitigate fines and penalties and to stop criminal proceedings being initiated.

While some changes to the structure of penalties ought to be immediate, wide-reaching changes should not be made until further research has been carried out. This research should, among other things, explore the relationship between penalties and taxpayers' behaviour. It could be that high penalties and low probability of detection might be a better deterrent than low penalties and a high probability of detection. But until further research is carried out we will not know.

7.3 REFORMS TO LIMIT TAX AVOIDANCE

7.3.1 Reforms to Limit the Opportunity for Income Splitting

Income splitting with family members was criticised for several reasons not least because it lowered the tax burden of the family without altering its income. Control and disposal of income often remained with the family member whose efforts produced it but ownership of the income

was split so that tax was avoided. Tax avoidance in Australia in this way is possible because of features of the Australian tax system. Firstly, the tax system imposes tax on income of individuals rather than on the income of a family unit, and secondly, the rate structure is characterised by a zero rate on the first slice of income (\$4,462 for 1982/83) followed by a progressive graduated scale. Table 4.1 showed that the tax avoided when income was split with others could be as high as sixty cents in the dollar. The actual amount depended on several features including a taxpayer's age, income, residential status and marital status. It was not suggested that tax avoidance necessarily took place *because* the tax rate was progressive but rather that the progressive scale ensured benefits for those who wanted to and who found ways to split income with others. If the opportunity for tax avoidance through income splitting is to be limited either the tax paying unit or the tax scale would have to be changed. Alternatively, individual income splitting devices would have to be separately dealt with. The latter, apart from being the most complex, has the defect that it can only operate after each device has been exposed. As the legislature becomes aware of particular devices it can enact laws which attempt to prevent them. This approach does not prevent tax avoidance until devices are outlawed and it does not discourage the search by taxpayers for alternative income-splitting techniques. It is also likely to increase the complexity of tax laws and such complexity might be a source of further avoidance opportunities. The simplest means of limiting the opportunity for tax avoidance through income splitting is by adopting a proportional tax rate. Alternatives are likely to be more complex and are unlikely to be neutral towards different business structures.

In Australia, a proportional tax rate of about 28% would, in 1979/80, have raised the same amount of tax as the existing progressive scale.¹⁸ Whether a proportional tax scale results in more or less government revenue will depend on several factors, including the rate which is set, but the most significant difference between a proportional tax and a progressive tax is not the amount of tax it raises but the alleged effect it has on income distribution. However, the effect that a proportional tax has on the distribution of income is difficult to assess because it depends as much on the amount of Government goods and services received as it does on the amount of tax taken. Adoption of a proportional tax may be no more than an explicit recognition of the incidence of tax for the majority of Australians. Based on household incomes of 1966-67 Bently, Collins and Rutledge concluded that "the incidence of all taxes [in Australia] combined is regressive at the lower household income levels, broadly proportional over the middle ranges of income and progressive at upper income levels."¹⁹ Other advantages of a proportional tax include -

- (i) it is neutral towards different business structures;
- (ii) it is mathematically simple and would, therefore, be easy to administer; and
- (iii) it has a less expansionary effect on total government revenue.

The case for a proportional tax system is so appealing that it is worth reconsidering why progressive tax structures exist. Presumably countries have progressive tax structures because the public want them. However, Blum and Kalvern argue that

... most people [are] interested only in the level of their own taxes and not in the ratio of that level to the tax burden on others with different incomes...²⁰

and that

... the progression issue is so far beyond the reach of public opinion that it is futile to talk of comparing expert opinion and public opinion. ²¹

Progression is also justified on "ability to pay" but this concept rests on several assumptions which are yet to be empirically tested. If it is possible to show that taxpayers have a diminishing marginal utility of income then it should *also* be possible to specify the degree of progression implied. Until there is more than intuitive support for these basic assumptions it is possible to support progressive, proportional or regressive taxes depending on the type of sacrifice assumed: equal marginal sacrifice, equal absolute sacrifice or equal proportional sacrifice. Musgrave notes that there tends to be agreement among ability to pay writers that marginal utility of income declines as one moves from very low to medium income but that there is less agreement for the higher income ranges. ²² He concluded that it was evident "that we lacked the information to apply any one of these three equity concepts [equal marginal sacrifice, equal absolute sacrifice and equal proportional sacrifice] in an objective fashion." ²³

Another reason put forward in favour of progressive taxes is that they redistribute income and wealth but if this is an important objective it should be possible to specify a rate structure that will produce a desired effect. Furthermore, if the income tax alone is progressive inequities in wealth may more than offset the redistributive effects of the progressive income tax. If the income tax system alone is progressive existing inequalities in wealth will be maintained because it retards the accumulation of new fortunes. Whatever the desired distribution of income and wealth the result can be obtained under any system. What a government does with money it raises is equally as

important as how it was raised. Under a proportional tax system low income earners can receive a higher proportion of goods, services and subsidies from the government than high income earners. The result achieved can be exactly the same as under a progressive tax system where benefits are distributed more evenly. In either case, the resultant distributions are based on political preferences; they have no logic about them. Gaps in the tax base, and avoidance and evasion opportunities further affect the equity of income distribution. Other arguments against progressive taxes include:

- (i) unless there are special rules within the tax system then taxpayers with income, subject to seasonal or other fluctuations, are harshly treated. The income of authors, inventors, ship builders, construction firms, primary producers and the like fall into this category. Their income may be the product of several years work and it seems unfair to tax it under a progressive scale in the year it is realised.
- (ii) such a system requires careful definition of certain rules. The questions of "*when* is income derived" and "*who* derives that income" are critical under a progressive tax system. It is only relevant under a proportional tax system if tax rates change.
- (iii) the implications of policy changes may be obscured under a progressive tax system. Knowledge of less variables is required under a proportional tax system.
- (iv) from the answers given to question 8 of the survey on tax avoidance (see 6.4), it seems that taxpayers facing high marginal rates of tax under a progressive rate structure will, most likely, be encouraged to undertake tax avoidance or evasion activities.

According to Mayek a proportional tax is more likely to be acceptable to taxpayers than a progressive tax:

It is the great merit of proportional taxation that it provides a rule which is likely to be agreed upon by those who will pay absolutely more and those who will pay absolutely less and which once accepted, raises no problem of a separate rule applying only to a minority. ²⁴

The case then for progressive taxation is not convincing. Even Blum and Kalvern, who try to restate the case for a progressive tax system had the following to say about it:

The price the tax system pays for progression is thus high. It produces a tax law of almost impenetrable complexity. It invites a distorting attention to the tax aspects of any transaction. It affords an excessive stimulus to tax avoidance with perhaps incalculable consequences for taxpayer morale and the general respect for the law. ²⁵

It is interesting to note that the Irish Commission on Taxation, which published its First Report in July 1982, favoured a proposal for levying income tax at a single and comparatively low rate - about 25%. The Commission recommended that corporation tax be set at the same rate and that income be redefined to include all net additions to spending power over time. ²⁶ In his commentary on the Commission's proposals Sandford asks: "If income tax is levied on a proportional basis all across the income ranges, how is progression to be retained in the tax system?" ²⁷ To answer this question he responds by saying that:

The Commission would argue that much of the present progressiveness is nominal, rather than real, because it is eaten up by tax reliefs, fringe benefits and forms of avoidance which particularly benefit the rich. Under the proposals, the elements of regressiveness would go. ²⁸

The same opportunities for tax avoidance, through income splitting, would not exist if the individual was *not* the taxpaying unit. For example, if the family unit was selected then many of the income splitting devices presently used would be ineffective. However, since income tax

was first imposed in Australia individuals have been called upon to pay tax on their own income. The Asprey Committee recognised this when it said "... women are playing an even greater role in the economic and other affairs of society, the withdrawal of this right would certainly be a retrograde step."²⁹ They concluded that any change from the present system to a system of compulsory aggregation would be politically unacceptable. Further, trends in individual taxation in other OECD member countries suggest that a movement towards compulsory aggregation of incomes is unlikely. Not only do more OECD countries operate on the basis of individual taxation but there has been a trend away from joint taxation by Denmark (1970), Sweden (1971), Austria (1973), Finland (1976) and Belgium (1976). The main reason given is the growing importance of the status and role of women.³⁰ It therefore seems unlikely that Australia would move away from the present system of levying tax on the taxable income of individuals.

7.3.2 Reforms to Limit the Conversion of Income into Capital

The second area of tax avoidance opportunities was converting income into capital. Tax would not be avoided if all receipts, whether income or capital, were similarly taxed. The absence of a tax on capital gains must be responsible for much of the avoidance that occurs. In all OECD countries which tax capital gains, taxation is on the basis of realised gains but this, as Table 7.1 shows, provides further opportunities for tax avoidance.

If (i) equity is to be achieved between taxpayers deriving income and those benefitting from capital gains; (ii) present tax avoidance opportunities of converting income into capital are to be limited; and (iii) the capital gains tax that is introduced is to be relatively free

TABLE 7.1

Avenues for Avoidance of Tax Under Systems Taxing
Capital Gains as They are Realised

<i>Features of Tax System</i>	<i>Avoidance Opportunity</i>
1. Taxation on disposal	. Circumventing definition of disposal e.g. conditional contract. . Retention of asset and accumulated gain.
2. Differential treatment of short term and long term gains	. Realisation of losses in the short term and gains in the long term.
3. Allowing offsets for realised losses	. Invites speculators who face high marginal rates of tax to realise losses. Assets may be immediately replaced with equivalent items.
4. Differential treatment of capital gains and (other) income gains	. Artificial transactions to escape the definitions altogether or to be taxed in the preferred manner.
5. Exemptions from tax base of certain assets, transactions or gains by certain taxpayers	. Switching investment to favoured assets or transactions or allowing preferred taxpayers to realise the gains.
6. Exemption of "small" gains from the tax	. Splitting assets into small units or rapid turnover of assets so that gains do not exceed the threshold.
7. Existence of "roll-over" provisions	. Adherence to provisions for losses but acquisition of marginally different assets for gains.

of avoidance possibilities, then capital gains must be taxed as they accrue. Any attempt to exempt or differentiate gains must be resisted if these goals are to be achieved. According to the Carter Commission "the complexity of the United States legislation is not the result of taxing capital gains, but rather is primarily a consequence of the United States decision to extend preferential treatment to capital gains". Canadian experience also suggests that where capital gains and income are distinguished tax laws tend towards complexity:

The most critical factor in reducing the relentless search of the taxpayer and his professional advisers for new ways of moving retained earnings out of the corporation - a search that has resulted in the introduction of the most complex Canadian legislation - is to narrow the differential between the taxation of dividends and capital gains. The adoption of a broad concept of income for Canada would, in itself, greatly reduce the uncertainty and administrative difficulties of our present legislation.³²

In outlining its case for taxing gains as they accrued the minority report of the Radcliffe Commission highlighted disadvantages of the alternative. They argued that taxation of realised gains would tempt taxpayers to hold onto assets and to realise losses (but not gains) and would cause inequities when gains were taxed in the year that they were realised.³³ The Carter Commission also favoured taxation of gains as they accrued:

To be consistent with the principle of the comprehensive tax base net gains on assets should in principle be brought into income annually, whether the gains were realised or not. This would preclude tax postponement, and if time were provided to pay the tax on the gains, serious liquidity problems could be avoided.³⁴

Against this background it must be remembered that -

- (i) an Australian Labor government failed, in 1974, in its attempt to introduce a tax on realised capital gains occurring after 17 September, 1974;
- (ii) a majority of tax agents (61%) disagreed with the statement that capital gains tax should be introduced *if* it would prevent tax avoidance (see 6.4);
- (iii) some taxpayers might be entitled to accrued capital losses even though they might have substantial wealth;
- (iv) some might perceive it wasteful to have annual valuations and payment of tax on accrued gains when, at a later time, values might well fall and require refunds of tax to be paid; and
- (v) others might see it as inequitable that assets might have to be realised to pay tax on accrued gains.

No simple solution exists especially for the problems involved in valuation. Perhaps a system which permitted taxpayers' own valuations to be accepted could be adopted. Safeguards could be built-in to impose penalties for gross undervaluations. Random checks could also be made on the disposal of assets and taxpayers could be penalised where they were unable to provide satisfactory explanation for large residuals which had not previously been taxed.

Assets which were genuinely difficult to value could be accounted for on the basis of cost plus an adjustment by a predetermined index number. Where taxpayers were unable to pay tax on accrued gains the tax, together with interest, could be paid when the asset was disposed of. Whether liquidity is a real problem or not depends on the taxpayer's own circumstances. Overseas experience suggests that liquidity might not be a significant problem because taxpayers who have the largest gains are, generally, those who also have the highest incomes.³⁵

In making a recommendation about capital gains, clearly the author's first preference is that capital gains be taxed, without differentiation or exemption, as they accrue. This should improve equity and should reduce many of the present avoidance opportunities. Experience with the tax should help overcome valuation and liquidity problems which are the two main objections raised against the above proposals. However, it must be significant that all OECD countries which impose taxes on capital gains impose them on *realised* gains. If gains are not to be taxed as they accrue then they must be taxed as they are realised. This then is the author's second preference. It therefore ranks above the present position of having no explicit capital gains tax at all.

7.3.3 Reforms to Reduce the Number of Exemptions to the Tax Base

The less exemptions there are to the tax base the fairer that base remains and the less opportunities for tax avoidance. This has been noted many times:

An income tax remains fair, however, only if it reaches all income, only if there are no preferences or loopholes through which some people can escape. The very integrity of the tax system is challenged today when many persons, especially those well off, are provided with readily available escapes.³⁶

These comments echo the sentiments of the Minority Report contained in the Radcliffe Commission who stated that:

When the base on which a tax is levied lacks precise definition the system is particularly exposed to the danger that successive concessions, designed to take care of special situations, will cause a progressive erosion of the tax base until its efficacy as an instrument of taxation is seriously weakened.³⁷

The Minority feared that the granting of concessions to one group would lead to the granting of concessions to others and, over time, this would lead to the tax burden being less equitably allocated. It seemed a far better policy, according to the minority, to have a much broader tax base and a lower rate of tax rather than the converse. The main purpose of comment here is to suggest ways of broadening the tax base. This includes, of course, taxing capital gains as they accrue, reducing scope for tax evasion and avoidance, and not providing deductions for such things as personal expenditures. Table 7.2 gives a summary of some of the changes which should be made to the Australian tax system to broaden the tax base. N.B. In July 1982 the Irish Commission on Taxation recommended that the Irish Government abolish most income tax reliefs presently existing in Ireland.³⁸

TABLE 7.2

Changes Required to be Made to the Australian Tax
System to Broaden Its Tax Base

<i>Item</i>	<i>Action Required</i>
1. Capital gains, gifts Windfall gains, Inheritance Bequests, and Retirement Allowances (i.e. Golden Handshakes)	Include as assessable income.
2. Property rates & taxes Hospital, medical & dental expenses Life assurance & superannuation contributions Education & self-education expenses Funeral expenses Calls on shares in afforestation companies Adoption expenses	Exclude from range of eligible concessional rebates.
3. Dependant rebates Zone allowances Housekeeper rebates Sole Parent rebates Health Insurance rebates Housing Loan Mortgage Interest rebates Pensioner rebates	Exclude as rebate of tax.
4. Living-away-from-home allowance Private expenses of preparing tax returns Election expenses for candidates for State or Federal Parliaments Charitable gifts Home Insulation costs	Exclude from deductible expenses.

Other aspects of the tax base which provided tax avoidance opportunities were outlined earlier (4.4) including the exemption from tax of certain ex-Australian source income derived by residents, the way in which fringe benefits were subject to tax and the ability of some taxpayers to postpone the derivation of income. The first of these invites

avoidance because the Act exempts residents from tax on most classes of foreign income which is subject to tax in the source country. To restore equity and reduce avoidance opportunities, all ex-Australian income derived by residents should be subject to Australian tax with a credit given for any ex-Australian tax already paid. But given Australia's commitment to seventeen or more double tax treaties this unilateral change seems unlikely. If rebatable dividends received by resident companies were also subject to tax in this fashion it would reduce the tax advantages to be gained from establishing companies in tax haven countries. Dividend income repatriated to Australia would then be fully taxed.

With fringe benefits the main difficulty, apart from ensuring the benefit is included as assessable income, is the problem of valuation. This could be handled in two ways: either standard values could be prescribed or acceptable methods of valuation could be described by the Commissioner. The question of ensuring fringe benefits are taxed is a problem of evasion and can be minimised by requiring PAYE instalments of tax to be made. Remedies have already been suggested to prevent avoidance of tax from schemes which attempt to postpone income (4.4.4). Essentially these reforms require the Act to prescribe *one* mode of derivation of income for *all* taxpayers, for example the accrual method.

7.3.4 Reforms to General Anti-Avoidance Legislation

Australia's general anti-avoidance provision from 1936 to 1981 was s.260 and this provision was replaced by Part IVA from 27 May 1981. The effectiveness of the latter is yet to be determined. It is, therefore, not known whether any reforms ought to be suggested. Time will tell but, judging from tax agents' opinions (see generally 6.5) about

the effectiveness of the new Part IVA, it is likely further changes will be required. Only 46% of agents responding to the survey on tax avoidance 'agreed' that "the new section 260 would probably be effective in preventing taxpayers from undertaking tax avoidance schemes." Of the remainder, 18% were undecided and 36% 'disagreed' with the statement. These doubts about Part IVA's likely effectiveness are strengthened when one looks at remedial legislation introduced after Part IVA was enacted. The Treasurer has introduced legislation to prevent exploitation of petroleum rebate provisions³⁹ and more recently he has introduced *further* legislation designed to prevent tax avoidance through trust stripping.⁴⁰ One might ask why it was necessary to introduce additional legislation, particularly the latter, if Part IVA was regarded as an effective anti-avoidance provision. One might also question the merits of using general provisions to prevent tax avoidance. The Radcliffe Commission did not favour the use of general anti-avoidance provisions to prevent tax avoidance:

We do not favour a departure from the present system of detailed legislative control of the various forms of tax avoidance that are thought to be obnoxious. Whatever the advantages of a different system which would confine the positive law to some general statement of principle, we are satisfied that it would only cause harmful confusion if our present system were to be abandoned in favour of the other.⁴¹

The Radcliffe Commission's stand against *replacing* the established processes of trial and error by an all embracing general anti-avoidance provision rested on several grounds including the fact that they tended to be "obscurely worded" and "drawn more widely than their original purpose required". As a result individuals' tax liabilities were determined "not by law but by the Special Commissioners".⁴² But there are problems with alternative approaches of preventing tax avoidance. For example, specific provisions, unless they are retroactive, will be

effective only where the draftsmen can foresee *the form* all tax avoidance arrangements will take. Specific legislation is also extremely detailed and might therefore expose new avoidance opportunities.

Another alternative is the use of retrospective legislation. This has, generally, not been favoured in Australia though some use has been made of it. For example, when legislation was foreshadowed to stop expenditure recoupment schemes, which exploited s.67, the Treasurer announced that similar schemes, arising in the future, would also be legislated against from the first announcement date (24 September 1978). Since then the Treasurer has introduced further legislation (4 August 1980) which has been effective from 24 September 1978. Retrospection in law-making has always been frowned upon and is precluded in respect of criminal law.⁴³ One could argue that if the principle is appropriate for criminal matters then it should also be appropriate for revenue matters. Judicial disapproval of retrospection in respect of revenue matters can be traced back to 1870 when Justice Wiles said:

... prima facie of questionable policy and contrary to the general principles that legislation by which the conduct of mankind is to be regulated ought, when introduced for the first time, to deal with future acts and ought not change the character of past transactions carried on upon the faith of the existing law.⁴⁴

Retrospection robs the law of a degree of certainty as it makes actions illegal which were formerly legal. The advantage of retrospective legislation is that its immediate effect on tax avoidance schemes is quite precise. Tax avoidance schemes can, therefore, be outlawed and the outcome of remedial legislation can be predetermined, unlike general provisions or administrative control provisions where the outcome remains uncertain. The power, or fear of, possible retrospective legislation should not be underestimated. According to one

report the announcement, in 1978, by the British Labor Government that it would introduce retrospective legislation to prevent tax avoidance "killed the tax avoidance industry in that country".⁴⁵ Recently, in Australia, the Australian Labor Party announced that it would introduce unlimited retrospective legislation to prevent tax avoidance if it was elected.⁴⁶ At that time the Liberal Government, although they did not dismiss the possibility of retrospective legislation, indicated that they felt it unlikely to be necessary.⁴⁷ Yet, only a month later, on 25 July 1982 the Treasurer announced that retrospective legislation would be introduced in order to make liable, in prescribed circumstances, shareholders of certain companies which have *evaded* liabilities for company tax:

The Government has decided to bring before the next sitting of the Parliament special legislation to recover from vendor shareholders the company tax that was evaded in 'bottom-of-the harbour' strips of untaxed company profits, carried out before the Crimes (Taxation Offences) Act 1980 made such conduct a specific criminal offence under Commonwealth law.⁴⁸

The amount of revenue lost through these schemes is unclear though the Treasurer has said that it is at least A\$450 million⁴⁹ (i.e. approximately stg £260m). But apparently loss of revenue is only one of the reasons given by the Treasurer for these measures:

In view of the revenue implications and having regard to the fraudulent nature of the scheme, the Government has concluded that, in the public interest, it must act to provide a simple and more certain avenue of recovery of the evaded company tax by way of the vendor shareholders who benefited from the scheme.⁵⁰

Some fear that if circumstances can arise where it is in the public interest to introduce retrospective legislation to prevent *evasion* of tax then circumstances might also arise where it will be in the public interest to introduce retrospective legislation to prevent *avoidance* of tax, if not by a Liberal Government then by a Labor Government.

Where general anti-avoidance legislation is introduced it should be coupled with "clearance procedures" to protect bona fide transactions and to prevent delays in the implementation of new ventures simply because of the fear of being (unintentionally?) struck down. Further, overseas experience has shown that the introduction of anti-avoidance measures must be coupled with increased powers for the revenue authorities to obtain information⁵¹ where tax avoidance is suspected. As yet no new powers have been introduced into the Australian Act. If Part IVA is to be effective this shortcoming should be remedied immediately because, at present, the Commissioner's powers to obtain information are defective.⁵²

7.3.5 Reforms to Improve Efficiency of Legislative Remedies

Analysis of the efficiency with which legislative defects were remedied was split into two parts: first, the speed with which defective legislation was amended, and second, the effectiveness of those amendments (4.6). Mainly because information on when defects come to the attention of the legislature was not available, comment was restricted to statements about the effectiveness of amendments. However, one of the most serious defects existing in Australian tax law is still to be remedied; namely the failure to tax capital gains. Other examples can also be given including the lengthy delays in preventing "Curran schemes" and the delay in introducing a new anti-avoidance provision. The original "Curran scheme" was undertaken in the 1968-69 tax year, yet remedial legislation did not come into effect until 16 August, 1977.

There were two developments over recent years which will improve anti-tax avoidance legislation: first was the establishment, in 1978, within the Taxation Office of a Compliance Division; the second was the

appointment, on 6 December 1979, of a Taxation Advisory Committee.

The Compliance Division is responsible for planning and co-ordinating administrative activity, at a national level, in relation to tax avoidance schemes whereas the Taxation Advisory Committee is responsible for providing advice to the Treasurer on technical aspects of tax legislation. Members of this Committee are chosen with this particular responsibility in mind although they will also be required, on some occasions, to give policy advice to the government. Unfortunately little has been heard of this committee since Part IVA was introduced.

Another recent development, at the international level, which is likely to improve anti-avoidance legislation is the establishment in 1977 of the Organisation for Economic Co-operation and Development's Committee on Fiscal Affairs. One of its working parties concentrates on tax avoidance and evasion and its work has concentrated on three areas:

- (i) improving the flow of information between tax administrations in respect of particular cases;
- (ii) improving exchanges of technical information between tax inspectors and auditors in the field of detecting tax avoidance and tax evasion; and
- (iii) improving exchanges of information between tax officials about recent legislative and administrative problems they have encountered. ⁵³

If the Australian Tax Office participates fully in these exchanges considerable benefits are likely to be forthcoming as many of the recent tax avoidance schemes marketed in Australia, including "dividend stripping" and "pre-paid interest" schemes, had their origins in North America and Europe. The working party discusses each new tax avoidance scheme as it is discovered in a member country. First, details of the

scheme are provided to representatives of each country and there follows a discussion of the practical, political and legal problems encountered so that other countries can learn from the experience of the country in which the schemes were discovered.

Doubtless other changes could also be made to improve the efficiency with which legislative defects are remedied but without more knowledge about Tax Office and Treasury practices it is difficult to make any firm suggestions.

Apart from quickly introducing amending anti-avoidance legislation such legislation should be free from defects. At times Parliament has let legislation slip through which has been ambiguous and incomprehensible. [See for instance s.80, ss.82KK-KL, s.99B-C, s.100A.] It would seem that if the Taxation Advisory Committee does not achieve its objectives then there would be a need for some form of *select committee* approach to screen proposed legislation. This committee would review draft legislation to see that it would have its desired effects and was free from technical defects.

7.4 OTHER REFORM PROPOSALS RELEVANT TO EVASION AND AVOIDANCE

Mention has already been made of the strict time limits imposed on taxpayers wishing to lodge objections or appeals (Table 3.8). No similar limits are imposed on the Commissioner of Taxation when he is required to make decisions on these appeals and no mechanism is available to relax the current requirements whatever the reason. This situation is unsatisfactory and consideration should be given to alternative practices. For instance, in the United Kingdom taxpayers are allowed to make late appeals if they have genuine reasons (e.g., if they have

been in hospital or if they have been overseas). Another practice, operating in the United Kingdom, which would improve the appeal process is the granting to senior tax officers of the power to settle appeals and impose penalties in consultation with the taxpayer at a regional level. This saves time and leaves the formal appeal process for the more serious disputes. At present there is an enormous number of objections waiting to be considered (201,376 were lodged in 1980/81) and very lengthy delays, up to two years, to have matters heard by Boards of Review. Even the Treasurer has recognised the lengthy delays that exist in having a matter heard by a Board of Review. In answer to a question in Parliament the Treasurer gave the following estimates of time which would be required to dispose of cases which, at 30 September 1982, were awaiting hearing:⁵⁴

*Time Needed to Dispose of
Cases Awaiting Hearing at
30 September 1982*

No. 1 Board	18 months
No. 2 Board	28 months
No. 3 Board	9 months

Alternative procedures to reduce the number of formal objections and reduce delays in the hearing of appeals must be considered. Suggestions are continually arising. For example, the Victorian President of the Taxpayers' Association of Australia suggested that the Taxation Office should set up a section to deal with small claims, requiring no more than the details an ordinary taxpayer could put on his own behalf.⁵⁵

This would allow the formal objection and appeal process to be reserved for more serious matters. However, without the establishment of more regional offices it is difficult to see how this suggestion would work. Alternatively, additional Boards could be established having only one member rather than having at present three members. Taxpayers would

have access to earlier hearings yet still have the right to appeal to a Court if they were dissatisfied with the Board's decision.

One practice, formally adopted under United States tax law, which should be considered is the process of advance rulings. This practice, which is also adopted in a number of other countries, reduces confrontation between taxpayers and revenue authorities because it reduces uncertainty. Taxpayers who are about to undertake business arrangements which have tax implications can submit them to the revenue authorities for approval. Once approved, any tax advantages which accrue are not subject to dispute. Economic decision making and risk taking is, therefore, not impaired by doubts over the tax consequences of proposed actions.

The need to amend s.243 of the Act and the need to issue "non-taxable" assessments has already been raised (3.7). Section 243, which allows for prosecution by averment, should be immediately withdrawn and replaced by a section requiring the Commissioner to produce evidence of matters alleged in prosecutions. Further, taxpayers should be entitled to "non-taxable" assessments where they lodge a return but have no taxable income. This would allow them to dispute assessments where, for instance, they had incurred losses but for tax purposes not all of those losses were allowed. At the present time no formal assessment is issued and this means that no objection or appeal can be made. This appeal process must wait until a later year when the taxpayer claims a deduction for the carry forward of past losses.

Alternative means of improving relations with taxpayers ought to be considered. Already mentioned is the need to establish a public relations department within the Taxation Office (7.2.4). This could

include the establishment of a taxpayers' service centre and the appointment of an Ombudsman within the Taxation Office. Such a service centre should seek to cut red tape where possible, to remedy errors quickly and to consider genuine cases of hardship for various matters, e.g. payment of tax. Tax forms and guides could be simplified and improved. One study on the comprehensibility of Australian tax forms and guides showed that they would be easier to read if an attempt was made to reduce the length of sentences in them.⁵⁶ Tax forms should also consider the Canadian practices of (i) issuing information circulars describing policies and practices adopted in dealing with tax avoidance and evasion; and (ii) defining, in simple terms, what is meant by the terms "tax evasion" and "tax avoidance".

All correspondence entered into by the Taxation Office with taxpayers ought to be carefully checked to see that information is accurate and timely and that any requests or directives are clear, polite and unambiguous. Confidence in tax administration could also be strengthened by abandoning small claims for unpaid taxes. Facilities to pay tax by way of instalment could also be considered where this would alleviate hardship.

Another important area is that of paying interest with refunds where refunds have been delayed. For example, where no refund has been received within six weeks of lodgement the refund should be paid with interest at commercial rates. Similarly, where taxpayers are late lodging their returns they should be liable to pay tax with interest.

On 10 August 1982, the Treasurer announced the Government's intention⁵⁷ to pay interest with refunds in a limited number of circumstances, *viz.* on income tax refunds following a successful objection

or appeal by the taxpayer. Interest will be calculated from the date the assessment was objected against, or the date the tax was paid, whichever is the later. However, it is unclear whether taxpayers will be better off under this new arrangement. At present the Commissioner allows half the tax in dispute to remain in abeyance until the objection is settled. In future this practice will, in almost all cases, be stopped. Consequently, *all* the tax due on an assessment will have to be paid in full on or before the due date. It is the intention that refunds resulting from objections will be repaid with interest. The rate at which the Tax Office will pay interest will be the rate applicable to long-term Treasury Bonds. At the time of the Treasurer's announcement this rate was about 6% less than the penalty rate of interest imposed on taxpayers for late payment of tax.

One question in the tax avoidance survey showed that tax agents thought that "self-employed" persons did not have adequate tax allowances for superannuation or retirement benefit contributions (Table 6.3). Changes should be made to improve the tax concessions available for such contributions. Self-employed persons should be treated no differently from employees and bringing the tax concessions available for both into line would do much to mitigate the feelings of inequity in this area. A majority of tax agents (65%) were also dissatisfied with the *time* it took the Tax Office to consider objections. Tax agents were also dissatisfied with the *time* it took the Tax Office to deal with other correspondence on income tax matters [57% of agents were dissatisfied (Table 6.3)]. Part of the Tax Office's problem may have been lack of staff and part may have been due to the increasing number of objections lodged against assessments. If staff levels are not to be increased then consideration should be given to ways to reduce the number of objections received. For instance, tax agents should be

forewarned of changes in assessment policies or if particular items are no longer regarded as allowable; tax agents ought to be advised of this before they prepare taxpayers' returns. Similarly where deductions will only be allowed in certain circumstances, then tax agents should again be advised of those circumstances. Where assessments are altered greater detail should be provided about the reasons for doing so. For relatively minor matters a less formal objection procedure might be implemented; for instance taxpayers could go to their local Tax Offices to have their disputes resolved.

It would seem that the Taxation Office should continue to challenge blatant, artificial or contrived tax avoidance schemes because this was the reason tax agents thought was most likely to discourage tax avoidance (6.5). In designing reforms to prevent tax avoidance the Government should encourage professional bodies, such as the Institute of Chartered Accountants, the Society of Accountants and the various Law Societies, to help. About half the tax agents responding to the avoidance survey believed that the accountancy profession should be actively engaged in designing reforms and 61% approved of the Institute of Chartered Accounts' plan to impose sanctions on members who promoted tax avoidance schemes.

The tax evasion survey also revealed that about three-quarters of all taxpayers were dissatisfied with our income tax laws [82% of "evaders" and 75% of "non-evaders" (Table 5.12)]. Further research needs to be done to see exactly what aspects of these laws cause discontent. Judging from the comments received consideration should be given to the system of paying tax by way of provisional tax, to the way in which overtime and interest are taxed, and to the objection and appeal process. Questions in the tax evasion survey relating to the

administrative control hypothesis also indicate areas where reforms could be made (Table 5.15). Apart from reforming the system of provisional tax, which caused dissatisfaction among 75% of "evaders" and 73% of "non-evaders", the area most in need of reform seemed to be official investigations by income tax officers. A majority of "evaders" (66%) and a minority of "non-evaders" (37%) were dissatisfied with official investigations. Part of this dissatisfaction would, of course, be because taxpayers were caught evading and were charged additional tax, but judging from the comments received part was due to the *way* in which taxpayers were treated during investigations. Attempts should be made to give tax investigation staff some training in dealing with people so that they can conduct tax audits and investigations without unnecessarily upsetting the taxpayers. This does not mean that staff should not enforce the law to the extent required, rather it means that they should carry out their duties as politely as possible and should, at all times, let taxpayers know what their rights are in the circumstances and see that these rights are respected. It would help if taxpayers subject to audits or investigations were given a brochure containing information about the audit or investigation process and their rights during, and after, it. More details could also be given with annual assessments when items of expenditure have been disallowed.

7.5 SUMMARY

Though it was not the central purpose of this thesis to provide a detailed list of changes to the Australian income tax system, quite a number of changes have been suggested in this chapter. Most of these changes are designed to reduce the scope for evasion or avoidance; some are designed to improve administration of the tax system. The

latter though might indirectly reduce the incidence of evasion or avoidance because taxpayers might feel the tax system is fairer.

However, in suggesting changes no attempt has been made to determine their likely cost. It is hoped that the cost would be small in relation to the likely benefits. Further, no attempt has been made to assess the recommendations against other criteria. For example, a number of the suggestions involved increased staff for the Tax Office and while these were designed to reduce evasion they might conflict with other criteria. It might add to the overall cost or complexity of running a large bureaucracy and this might outweigh the benefits sought.

Further, some of the changes suggested, such as a flat rate tax and a tax on capital gains, are such fundamental changes that they should *not* be introduced overnight. Time and care should be taken in drafting them. Other changes require the gathering of more information - information about people. This, though it might reduce evasion or avoidance, might be at the expense of undue invasion of their privacy. Some trade-offs might therefore be necessary before more controls are introduced. If the tax system is to survive and operate efficiently it requires acceptance by taxpayers and a commitment by them to co-operate. Unless tax laws are *seen* to be fair, unless Governments are *seen* to spend taxpayers' money wisely, unless other taxpayers are *seen* to comply, then taxpayers will always be dissatisfied. The role of the media in improving taxpayers behaviour should also be fully explored.

FOOTNOTES TO CHAPTER SEVEN

1. *Estimates of Income Unreported on Individual Income Tax Returns* 1979, Department of the Treasury - Internal Revenue Service U.S., p.(iv).
2. Report by Donald Lubick, U.S. Treasury assistant secretary. See *The Economist*, 29 September, 1979, p.86.
3. For instance since 6 April 1978, where directors or employees, earning more than £7,500 are provided with a car by reason of their employment, schedules exist indicating the weekly/fortnightly amount required to be added to their other income for tax instalment purposes.
4. One exception is interest paid or credited by banks who are not required to withhold tax. However in 1975/76 a Board of Inland Revenue survey revealed that 149,000 taxpayers failed to disclose bank interest on their returns.
5. *Estimates of Income Unreported on Individual Income Tax Returns*, *op. cit.* See in particular the Waterman Project - Baltimore District.
6. There is one other constraint, i.e. that taxpayers income is below a particular level, presently US \$20,000.
7. *Estimates of Income Unreported on Individual Income Tax Returns*, *op. cit.*
8. In particular see comments on the Baltimore Waterman Project conducted by the I.R.S. Reported in *Planning Model Study - Interim Report*, Criminal Investigation Division, Department of the Treasury, USA 1978.
9. Present coefficients are based on a thorough audit of a random sample of 50,000 returns for the 1973 tax year.
10. *Planning Model Study - Interim Report*, *op. cit.*, see attachment 14.
11. Groves, H.M., "Empirical Studies of Income Tax Compliance, *National Tax Journal*, 4, 1958, pp.291-301. Claims for rates and taxes were checked with local authorities, heating costs were verified from engineering estimates and other expenses such as electricity, repairs and maintenance were each estimated.
12. Such action first requires the sanction of an approved judicial body e.g. a circuit judge [in England].
13. *Sun Herald*, 6 September 1981, pp.1-2.
14. Under the United States Internal Revenue Code penalties are structured according to the nature of the offence. For instance, the penalty for evasion through negligence is 25% of the deficiency whereas for civil fraud it is 50%.

15. Silberman, M., "Towards a Theory of Criminal Deterrence", *American Sociological Review*, 1976, Vol.41, pp.442-461.
16. *Ibid*, p.443.
17. Criminal prosecutions now only exist where taxpayers obstruct tax officers in carrying out their duties or where tax officers are impersonated by taxpayers.
18. The rate of tax was calculated as follows:

$$\frac{\text{Net Revenue Collected (1979-80 Individuals)}}{\text{Net Income (1979-80 Individuals)}} \times \frac{100}{1} = \frac{18,587,704}{66,515,216} \times \frac{100}{1}$$

$$= 27.95\%$$

Source: 60th Annual Report of the Commissioner of Taxation,
 Canberra: Aust. Govt. Printer, 1981.
19. Bently, P.R., Collins, D.S. and Rutledge, D.J.S., "Incidence of Australian Taxation: Some Further Results", *Taxation Review Committee: Commissioned Studies*, Canberra: AGPS, 1975, at p.190.
20. Blum, W.J. and Kalvern, H. Jr., *The Uneasy Case for Progressive Taxation*, Univ. of Chicago Press, 1963, at p.x.
21. *Ibid*, p.xi.
22. Musgrave, R.A., *The Theory of Public Finance: A Study in Public Economics*, Tokyo: McGraw-Hill KogaKusha Ltd, 1959, at p.108.
23. *Ibid*, p,108.
24. Hayek, F.A., *The Constitution of Liberty*, London: Routledge, & Kegan Paul, 1960, at p.314.
25. Blum, W.J. and Kalvern, H. Jr., *The Uneasy Case for Progressive Taxation*, *op. cit.*, pp.18-19.
26. Sandford, C.T., "Ireland Shows the Way in Tax Reform", *Accountancy*, September 1982, pp.18-19 at p.18.
27. *Ibid*, p.18.
28. *Ibid*, p.18.
29. *Asprey Committee, op.cit.*, para. 10.16.
30. O.E.C.D., *The Treatment of Family Units in OECD Member Countries under Tax and Transfer Systems*, Paris: OECD, 1977, p.9.
31. *The Taxation of Capital Gains*. Studies of the Royal Commission on Taxation, Vol.19, Canada, February 1967, p.10.
32. *Ibid*, p.11.
33. *Radcliffe Commission, op. cit.*, para. 62 of the Minority Report.
34. *Carter Commission, op. cit.*, pp.56-57.

35. *Ibid*, especially p.6 where it was reported that, at that time, three-quarters of all capital gains realised in the U.S. were by taxpayers with incomes in excess of \$10,000.
36. Surrey, "Taxes are a Moral Issue", *Saturday Review*, 21 October 1972, p.51.
37. *Radcliffe Commission*, *op. cit.*, para. 24.
38. See Sandford, C.T., "Ireland Shows the Way in Tax Reform", *op. cit.*, p.18.
39. C.C.H., *Federal Tax Reporter*, Cumulative Index of New Developments, p.61803.
40. *Ibid*, p.61877.
41. *Radcliffe Commission*, *op. cit.*, para. 1029.
42. *Ibid*, especially paras. 1029(4) and 1029(5).
43. Retrospectivity is precluded by Article 11(2) of the *Universal Declaration of Human Rights* (1949) and Article 7 of the *Convention for the Protection of Human Rights and Fundamental Freedoms* (1953), and more recently Article 15 of the *International Covenant on Civil Liberties*.
44. *Phillips v Eyre* (1870) L.R. 6 QB 1.
45. *Newcastle Morning Herald*, 21 March 1981, p.1.
46. See *Sydney Morning Herald*, 10 June 1982, p.3.
47. See statements made by the Treasurer in his address to the Darwin Press Club, 8 June 1982. Reported in *Financial Review*, 9 June 1982, p.1.
48. Quoted in "Retrospective Legislation for Company Tax", by I.C.F. Spry, *Australian Tax Review*, September 1982, pp.152-158 at p.152.
49. *Ibid*, p.152.
50. *Ibid*, p.154.
51. For instance, see s.231(9) of the Canadian Act.
52. See Chapter Three at section 3.5.3.
53. O.E.C.D., "Work on Tax Avoidance and Evasion", *Intertax*, Jan.1980/1, pp.9-16.
54. *The Taxpayer*, 27 February 1982, p.45.
55. *Australian Federal Tax Reporter*, CCH Sydney, Report No.483, 19 November 1982, p.4.
56. S. James, A. Lewis, I.G. Wallschutzky, "Fiscal Fog: A Comparison of the Comprehensibility of Tax Literature in Australia and the United Kingdom", *Australian Tax Review*, Vol.10, No.1, March 1981, p.34.
57. *The Australian Income Tax Weekly Summary*, Butterworths 1982, 20 August 1982, No.36.

CHAPTER EIGHT

CONCLUSIONS

8.1 INTRODUCTION

Evasion and avoidance of income tax in Australia has, over the last decade, reached alarming proportions; so much so that

- (a) a Royal Commission estimated that *one* evasion practice (known as "bottom-of-the-harbour schemes") could have lost the Commonwealth Government "hundreds if not thousands of millions of dollars".¹
- (b) the Commonwealth Government, 1 December 1982, passed laws *retrospective in effect to 1 January 1972* to help recover some, if not all, of the evaded tax from the so-called "bottom-of-the-harbour schemes".²
- (c) the Prime Minister addressed the nation to explain the Government's campaign against tax evasion and avoidance.³

Unfortunately there has been little published in Australia on the possible causes of evasion or avoidance. In this thesis an attempt was made to determine some of the causes. To this end the thesis was divided into two parts: firstly, the tax system itself was analysed to see how it might have contributed; secondly, an attempt was made to determine why taxpayers wanted to evade or avoid. In the pages that follow there is a summary of the conclusions of this thesis. These conclusions extend to both of the above aspects, *viz.* systemic weaknesses which provide opportunities for evasion and avoidance and taxpayers' motives for wanting to evade or avoid.

8.2 CONCLUSIONS REGARDING THE OPPORTUNITY, IN THE AUSTRALIAN INCOME TAX SYSTEM, FOR EVASION AND AVOIDANCE OF INCOME TAX

As a prerequisite to determining the opportunities for evasion and avoidance, it was necessary to distinguish what was meant by the two terms. In part, this was the function of Chapter One where, at 1.6, it was concluded that:

- *Tax evasion* was an act in contravention of the law whereby a person paid less tax than he was legally bound to pay. Evasion presupposed that a liability for tax had already fallen on a taxpayer who *then* took steps to *escape payment* of the tax.
- *Tax avoidance* was an act, carried out by means which were within the law, whereby a person paid less tax than he would have paid but for those means. The distinguishing feature about tax avoidance was that the taxpayer took steps to get out of the way of the *tax liability before it fell on him*. The means by which this was achieved often lacked commercial purpose, other than avoidance of tax, involved complex legal manoeuvres and involved some degree of secrecy.

Though the definitions involved more than that outlined above (see generally 1.4 and 1.5) and although there were other aspects of evasion and avoidance⁴ (1.2), the above seems sufficient for present purposes. Given these definitions it appeared that, in the Australian income tax system, there was considerable scope for both activities. In Chapter Three it was found that inadequate tax collection practices (3.3), inadequate record keeping requirements (3.4), inadequate resources used to detect evasion (3.5) and inadequate penalties for evasion (3.6) were the main systemic weaknesses which provided scope for evasion. Analysis in Chapter Four revealed systemic weaknesses which provided scope for avoidance. Among the main defects were the ease with which taxpayers were able to split income with others (4.2) and the opportunities that existed for converting income into capital (4.3). Other defects included the large number of exemptions from the tax base (4.4),

the inadequacy, between 1936-1981, of the anti-avoidance provisions (4.5), and the delays that have occurred in remedying defects in the legislation (4.6).

It should be stressed that these systemic weaknesses may not necessarily have been a bad thing. They could, for example, have provided for some taxpayers a necessary safety valve. This may have meant the difference between small scale evasion or avoidance and outright tax revolt. Alternatively, a tax system free of these defects may have been far too complex or too expensive to administer. However, one cannot overlook the fact that the opportunities to evade and avoid were not available to all taxpayers. If for no other reason an attempt should be made to reduce such opportunities so that *equity* between taxpayers can be restored. Wage and salary earners have had least opportunity to evade because tax has been deducted at source and they have had little opportunity to avoid tax by splitting income with others. Attempts to assign wage and salary income have failed.⁵ Purported assignments of wage and salary income are still ineffective for tax purposes because there is no presently existing right to future income in existence at the time of making any agreement. All that exists is a mere expectancy. The parties can agree to assign the income once it has come into existence but then it is too late to avoid tax. Tax accrues as soon as the income is derived and payment of that income to another person is merely an *application* of income rather than an *alienation* of it.⁶

To restore equity and to limit the scope for avoidance and evasion, reforms are required. While it was not the purpose of this thesis to examine possible reforms, some policy options were considered. It was decided that among the reforms which ought to be considered to

reduce the scope for evasion were

- (i) extension of the principle of deduction of tax *at source* to income consisting of interest, dividends, annuities and mining rents (7.2.1);
- (ii) enactment of provisions requiring a minimum set of books of account that should be kept and accounting procedures that should be followed (7.2.2); and
- (iii) a review of the penalties that are imposed for detected evasions (7.2.3). These penalties should apply at a predetermined rate so as to be commensurate with the offence.

To reduce opportunity for avoidance, the following reforms were suggested:

- (i) the introduction of a flat rate of tax (7.3.1) - or at the very least a rate not as sharply progressive as the existing rate;
- (ii) the extension of the tax base to catch all capital gains (7.3.2); and
- (iii) a restriction in the number of exemptions from the tax base (7.3.3).

8.3 CONCLUSIONS REGARDING AUSTRALIAN TAXPAYERS' MOTIVES FOR WANTING TO ENGAGE IN TAX EVASION AND AVOIDANCE

8.3.1 Conclusions about the Evasion Survey

Two nationwide surveys were conducted to help determine what might influence Australian taxpayers to evade or avoid tax. The first survey, dealing with evasion (5.3), obtained and compared information from two different survey populations, *viz.* an "evader" population and a "non-evader" population. The same questionnaire was distributed to each and, among other things, three hypotheses about taxpayer behaviour

were tested. These hypotheses were referred to as "the exchange relationship hypothesis", "the social orientation hypothesis" and "the administrative control hypothesis" (2.6). Statistical tests of significance were applied to responses from each group and it was found (5.4) that

- (i) there was no statistically significant difference of opinion between "evaders" and "non-evaders" on questions relating to "the exchange relationship hypothesis";
- (ii) there was a statistically significant difference of opinion between "evaders" and "non-evaders" for - *some but not all* (in fact in three out of five cases) - questions relating to "the social orientation hypothesis"; and
- (iii) there was a statistically significant difference of opinion between "evaders" and "non-evaders" for almost all (three out of four) questions relating to "the administrative control" hypothesis.

At first sight there seemed to be little support for "the exchange relationship hypothesis". However, judging from the comments received (5.7), this was the element regarded most likely to influence taxpayers' behaviour. Evaders, in particular, justified their actions because they believed that tax rates were too high, that high income earners had more opportunity to avoid tax and that the Government wasted taxpayers' money. Non-evaders had similar views. There was ample questionnaire support to verify these claims and this is summarised in Table 8.1.

After respondents' comments were considered (5.7.2) and the above information tabulated it was considered that "the exchange relationship hypothesis" embodied the most important motivating influences.

TABLE 8.1

Summary of Some Responses, in the Tax Evasion
Survey, to Questions Relating to the Exchange
Relationship Hypothesis

	<i>Evaders</i>	<i>Non-Evaders</i>
1. Percentage of respondents who thought that tax rates were "too high" in relation to the amount they earned	89%	85%
2. Percentage of respondents who were dissatisfied with the way the Federal Government spent taxpayers' money	72	73
3. Percentage of respondents who were dissatisfied with our income tax laws	82	75

This meant that some other reason had to be found to explain the lack of statistical difference between the responses from the "evader" population and the "non-evader" population. It seemed that either the methodology was defective or that there might be just as many evaders in both populations. Responses to some of the other questions (Table 5.8) tended to suggest the latter might be the case. For example, when respondents were asked about their likely action in respect of part-time cash earnings of \$100 (i.e. whether to declare for tax purposes or whether to omit it), about two thirds of respondents from each group (the evader group and the non-evader group) said that they would omit the earnings.⁷

The other implication of the conflict between the results obtained from statistical analysis and results obtained from an analysis of respondents' comments, was that the methodology used was defective. Consequently, at 5.5, the data were retested using "traditional methodologies". However, the results obtained were less satisfactory.⁸

Not only were there very few significant differences but some of the differences conflicted with prior traditional theory (5.5.2). Other differences were apparent with one of the traditional methodologies but not the other. This suggested that choice of methodology could influence the results obtained. This same comment about the influence of the choice of methodologies must be made about the methodology used in 5.4.

If the traditional methodologies supported any of the three hypotheses, it was likely that it was "the administration control hypothesis". In particular, one of the traditional methodologies indicated a strong relationship between the way in which the Tax Office dealt with taxpayers' annual returns and their membership of one of the groups (*viz.* evader or non-evader). However the causal factor or independent variable could not, with certainty, be identified.

8.3.2 Conclusions about the Avoidance Survey

For various reasons (6.1) the avoidance survey (6.3) elicited responses from tax agents about taxpayers' behaviour rather than from taxpayers about their own behaviour. In addition tax agents were asked about various reform proposals. The survey, though less ambitious and less sophisticated than the evasion survey, was more positive in its conclusions.

The reason given by almost three-quarters of tax agents for taxpayers *most* wanting to engage in tax avoidance was that they (the taxpayers) thought the amount of tax they had to pay in relation to the amount of money they had earned was too high (6.4). This, of course, is one of the aspects of the "exchange relationship hypothesis". Comments received from tax agents (6.7) also supported this finding.

Most comments made connected tax avoidance with high rates of tax. Some comments indicated other influences but these were generally related to "the exchange relationship hypothesis". The connection between high rates of tax and tax avoidance was not altogether surprising because it has often been alleged that those who undertake avoidance schemes were high income earners. The strength of the suspected relationship between tax avoidance and high rates of tax was further explored with another question concerning the most likely reaction of professional persons whose incomes reached the level where they were liable to pay tax at the 60% rate. Almost four-fifths of tax agents thought that such taxpayers would "continue to earn, but look for ways of reducing their tax burdens by legal means". Ten percent of tax agents thought the most likely response would be tax evasion and only eight percent thought that work effort would be reduced (Question 8, 6.4).

In respect of the question concerning factors which would *most* discourage taxpayers from undertaking tax avoidance (Question 7, 6.5) schemes, a greater variety of responses was obtained. However, the most significant influence seemed to be the possibility of protracted legal battles with the Tax Office. Responses to questions concerning the likelihood of future avoidances (6.5) of tax were divided. Forty-seven percent felt that the new anti-avoidance provisions (Part IVA) would be effective in preventing tax avoidance whereas 35% thought that it would not be effective.

There was also a mixed reaction to the extent to which the accountancy profession should be involved in designing reforms to prevent tax avoidance with only about half (49%) agreeing that the profession should be involved, the remainder either disagreeing (37%)

or being undecided (14%). One reform proposal which met with little approval was the proposal of a capital gains tax. Only 32% of tax agents agreed that it should be introduced *IF* it would prevent tax avoidance [Question 2(d), 6.6]. Some 61% disagreed and 7% were undecided.

8.4 THE INFLUENCE OF TAX RATES - SOME CONCLUDING REMARKS

One of the main findings of this thesis was the strong positive relationship seen to exist between evasion/avoidance and high tax rates (5.8 and 6.8). Perhaps the high levels of evasion or avoidance (indicated in the Annual Reports of the Commissioner of Taxation and elsewhere) are, in part, attributable to the Government's increased emphasis on income tax relative to 'other' taxes as Table 8.2 shows:

TABLE 8.2

Revenue Collections by the Commonwealth Taxation Office* Expressed as a Percentage of Total Revenue Collections

	<i>Income Taxes</i>	<i>Sales Tax</i>	<i>Other Taxes**</i>	<i>Total</i>
1948-49	78%	11%	11%	100%
1964-65	80	12	8	100
1980-81	91	8	1	100

Source: *Annual Reports of the Commissioner of Taxation* (figures rounded).

* These figures do not include collection of customs and excise duties which at present account for slightly less than a quarter of total Commonwealth tax receipts. N.B. In 1948-49 such duties accounted for slightly more than a quarter of total Commonwealth tax receipts.

** Includes payroll tax, land tax, estate duty, gift duty, entertainment tax, wool tax, stevedoring industry charges, tobacco charges and canning fruit charges.

Table 8.2 shows that income tax accounted for about 78% of revenue collections by the Commonwealth Taxation Office in 1948-49 and for over 90% in 1980-81. When Table 8.3 is analysed it is clear that much of the increased burden of income tax has fallen on wage and salary earners (i.e. the P.A.Y.E. category). Separate figures are not available for 1948-49 but they are available for the latter two financial years. In 1964-65 some 43% of income tax collections were from wage and salary earners but this percentage had increased by almost 50% to 64% in 1980-81. Over the same period the percentage of income tax collected from companies had fallen from 31% in 1964-65 to 21% in 1980-81. The percentage of income tax collections from individuals other than wage and salary earners had also declined over this period - from 26% in 1964-65 to 15% in 1980-81.

The growing burden of income tax, especially the burden on wage and salary earners, is again evident in Table 8.4. It shows tax payable on average earnings as a percentage of average earnings. The figures have been obtained by assuming a single person would have earned the average weekly wage throughout the whole of the year of income and would not have been entitled to any deductions or rebates. In 1948-49 that person would have been required to pay about 6% of his earnings in income tax whereas in 1980-81 the corresponding amount would have been 23% - *almost a fourfold increase!*

The impact of marginal rates of tax is perhaps more of a problem. For 1981/82 average weekly earnings for male workers was \$328.70 and given that they will increase by an amount roughly equivalent to the rate of increase for the previous twelve months then one would expect average earnings for 1982/83 to be about \$384 per week or \$19,968 per annum. Under the revised tax scale for 1982/83 the middle rate of tax

TABLE 8.3

Percentage of Income Tax Collections from Individuals and Companies

	<i>Individuals</i>			<i>Companies</i>	
	<i>PAYE</i>	<i>Other</i>	<i>Total</i>		<i>Total</i>
1948-49	n.a.	n.a.	73**	27	100
1964-65	43	26	69	31	100
1980-81	64	15	79	21	100

N.B. The P.A.Y.E. category is equivalent to a wage and salary earner category.

** Separate figures did not become available until 1963-64.

Source: *Annual Reports of the Commissioner of Taxation.*

TABLE 8.4

Tax Payable on Average Income* Expressed as a Percentage of Average Income

	%
1948-49	6
1964-65	15
1980-81	23

* Average Income = Average Weekly Earnings x 52.

Sources: Australian Bureau of Census & Statistics (for average weekly earnings), and Gunn's *Income Tax Guides* and Mannix's *Income Tax Guides* (for tax rates).

of 46% applies to taxable incomes of \$19,500 and over. Therefore, for the first time, in the 1982/83 tax year average earnings will be taxed *at the margin* at 46% whereas previously the rate was the standard rate (32% for 1981/82). The likely effect of this on avoidance and evasion is only too apparent.

The message is clear that the perceived burden of personal income tax rates must be reduced. This can be done in a number of ways, the simplest of which is that of reducing the tax rates. It seems far too severe that in two steps the marginal rate almost doubles [from 30.67% to 60% - 1982/83 rates]. If Government revenue requirements cannot be cut to accommodate this change then further reliance should be placed on indirect taxes. Alternatively, if income tax rates are not to be reduced then existing inequities ought to be eliminated and taxpayers should be better informed as to how their money is used. It is likely that taxpayers who believe they are getting more value for their tax dollar are likely to be less motivated to evade or avoid. Thus more attention should be given to effectively communicating, with taxpayers, information about Government spending.

FOOTNOTES TO CHAPTER EIGHT

1. Costigan Royal Commission into the Federated Ship Painters' and Dockers' Union, First Volume of the Fourth Interim Report. Statements quoted in *Financial Review*, 25 August 1982, pp.1 & 8.
2. C.C.H., *Special Income Tax Report*, 24 September 1982, p.1.
3. *Financial Review*, 28 September 1982, p.5.
4. For instance, see R.B. Cross and G.K. Shaw, "The Evasion-Avoidance Choice: A Suggested Approach", *National Tax Journal*, Vol.XXXIV, No.4, pp.489-491 who argue, legal consequences aside, the two should be analysed jointly because economic determinants and consequences are the same.
5. See, for example, 2 CTBR (NS) Case 68 or 20 CTBR (NS) Case 11.
6. See s.19 of the *Income Tax Assessment Act* 1936 as amended.
7. See Table 5.28 for full details.
8. See Chapter Five at section 5.5.

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Cridland v FCT (1978) 78 ATC 4538
Curran v FCT (1974) 74 ATC 4296
Cyprus Mines Corporation v FCT (1978) 78 ATC 4468
Denver Chemical Manufacturing Company v C of T (NSW) (1949) 79 CLR 296
FCT v ANZ Banking Group (1979) 9 ATR 483
FCT v Bevz (1981) 11 ATR 776
FCT v Commonwealth Aluminium Corp. Ltd (1980) 11 ATR 42
FCT v Coppleson (1981) 81 ATC 4550
FCT v Mitchem (1965) 9 AITR 559
FCT v Phillips (1977) 7 ATR 345
FCT v Reynolds (1981) 81 ATC 4131
FCT v Smorgan (1979) 79 ATC 4039
FCT v Westgarth (1950) 81 CLR 396
Ganke v FCT (1975) 75 ATC 4097
Ganke v D.F.C.T. (No.2) (1982) 82 ATC 4474
Gibb v FCT (1966) 118 CLR 628
Gorton v FCT (1965) 38 ALJR 353
Hayes v FCT (1956) 6 AITR 248
Henderson v FCT (1970) 1 ATR 596
Ilbery v FCT (1981) 81 ATC
IRC (NZ) v Parker (1966) 1 All E.R. 399
Karaskas v Kelton (1981) 81 ATC 4122
McIntosh v FCT (1978) 78 ATC 4324
McLaurin v FCT (1961) 8 AITR 180
Mangin v IRC (NZ) (1970) 1 ATR 835
Mullens v FCT (1981) 81 ATC 4643

N.F. Williams v FCT (1972) 72 ATC 4190
Newton v FCT (1958) 98 CLR 1
Partrington v Attorney General (1869) LR 4 HL 100
Phillips v Eyre (1870) LR 6 QB 1
Rabinov and Anor v FCT (1982) 82 ATC 4517
Ramsay v CIR (1981) 2 WLR 449
Re Prince: Ex Poste the Bankrupt (1961) ALR 889
Reseck v FCT (1975) 5 ATR 538
Russell v Scott (1948) AC 22
Scanlan (D.F.C.T.) v Swan (1982) 82 ATC 4402
Scott v FCT (1967) ALR 561
Slutzkin v FCT (1977) 77 ATC 4076
Stanton v FCT (1955) ALR 912
Tennant v Smith (1982) ACT 150
Westraders Pty Ltd v FCT (1980) 80 ATC 4357

APPENDIX 1

EVASION SURVEY MATERIAL

This appendix contains a copy of: _

- (i) The advance letter,
- (ii) The letter accompanying the questionnaire,
- (iii) The questionnaire and responses to each question, and
- (iv) The follow up letter.



THE UNIVERSITY OF NEWCASTLE
NEW SOUTH WALES, 2308

351

Telephone 68 0401

683 or 735
Area Code:
(049)

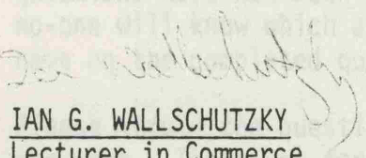
Department of Commerce

Dear

Many people complain about paying taxes but few people seem to do anything about it. I am conducting a research project to determine exactly what the public thinks. You can help.

In a few days you will receive a questionnaire. If you would like to help, complete it and return it to me. It will not take up much of your time and your answers will be important to the success of this project.

Yours sincerely,


IAN G. WALLSCHUTZKY
Lecturer in Commerce

Yours sincerely,

IAN G. WALLSCHUTZKY
Lecturer in Commerce

P.S. Enclosed is a complimentary slip to help you complete the questionnaire. Please keep this slip as a token of my appreciation for helping with this project.



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Department of Commerce

Dear

This is the questionnaire I wrote to you about a few days ago. The questions seek *your* answers about various aspects of taxation. Unless your views are expressed they cannot be taken into account in determining public opinion. The questionnaire is not related to any Government Department or political party so you can say what you really think.

Your address has been taken from the electoral rolls and I hope you can spare the time, about fifteen minutes, to complete these questions. You will find the questions interesting and you will be helping my research by answering them. You might also be helping to influence future taxation policies which will affect your life.

Your answers will be treated in the *strictest confidence*. The questions have not been marked or coded in any particular way so no-one will know which answers are yours. Also do not put your name on the completed questionnaire.

Please *return* the questionnaire in the reply paid envelope within one week. Thank you for your co-operation.

Yours sincerely,

IAN G. WALLSCHUTZKY
Lecturer in Commerce

P.S. Enclosed is a complementary biro to help you complete the questionnaire. Please keep this biro as a token of my appreciation for helping with this project.

		<u>Much Too High</u>	<u>A Little Too High</u>	<u>About Right</u>	<u>A Little Too Low</u>	<u>Much Too Low</u>	
1. What do you think about the amount of income tax you pay <i>compared with</i> the amount:							
(a) you earn?	EV* 117	67	20	3	-	= 207	
	NE 95	78	27	3	2	= 205	
		(no difference)**					
(b) of Government services from which you, and any dependents you might have, personally benefit?	EV 85	27	40	27	28	= 207	
	NE 72	45	35	34	19	= 205	
		(no difference)					
		<u>Very Satis- fied</u>	<u>Somewhat Satis- fied</u>	<u>Indiff- erent</u>	<u>Somewhat Dissat- isfied</u>	<u>Very Dissat- isfied</u>	
2. How do you feel about:							
(a) the way the Government in Canberra spends your money?	EV 4	40	14	85	64	= 207	
	NE 3	35	18	82	67	= 205	
		(no difference)					
(b) income tax laws in this country?	EV 2	22	14	76	93	= 207	
	NE 1	33	19	73	79	= 205	
		(no difference)					
(c) other laws in this country?	EV 16	72	29	67	23	= 207	
	NE 3	74	39	67	22	= 205	
		(significant difference)					
(d) the way you have been treated in dealings with Government Departments?	EV 17	63	35	44	48	= 207	
	NE 18	61	38	52	36	= 205	
		(no difference)					

* Legend	<u>Sample Size</u>	<u>Useable Responses</u>	<u>Response Rate</u>	
EV = "Evaders"	500	207	41%	(no difference)
NE = "Non-Evaders"	500	205	41%	

** Chi-Square tests were used; P = 0.05

(except where test is shown to be ANOVA wherein analysis of
variance tests were used; F = 0.05)

		<u>Strongly</u> <u>Approve</u>	<u>Slightly</u> <u>Approve</u>	<u>Indiff-</u> <u>erent</u>	<u>Slightly</u> <u>Dis-</u> <u>approve</u>	<u>Strongly</u> <u>Dis-</u> <u>approve</u>	
--	--	-----------------------------------	-----------------------------------	--------------------------------	--	--	--

3. How do you feel about the following:

Someone, in similar circumstances to your own, who omits ...

(a) \$100 cash earnings from his income tax return

EV	27	38	84	44	14	= 207
NE	13	39	75	48	30	= 205

(significant difference)

(b) \$1,000 cash earnings from his income tax return

EV	18	20	60	78	31	= 207
NE	6	25	45	66	63	= 205

(significant difference)

(c) \$10,000 cash earnings from his income tax return

EV	13	7	42	57	88	= 207
NE	4	6	29	46	120	= 205

(significant difference)

Questions

	<u>Not</u> <u>Applic-</u> <u>able</u>	<u>Very</u> <u>Sat-</u> <u>isfied</u>	<u>Somewhat</u> <u>Satis-</u> <u>fied</u>	<u>Indiff-</u> <u>erent</u>	<u>Dissat-</u> <u>isfied</u>	<u>Very</u> <u>Dissat-</u> <u>isfied</u>
--	---	---	---	--------------------------------	---------------------------------	--

4. How satisfied are you with each of the following?

(a) the efficiency of the Income Tax Office in dealing with your annual return.

For example:

(i) the time it takes to deal with your annual return

EV	17	58	58	33	27	14	= 207
NE	26	59	70	12	25	13	= 205

(significant difference)

(ii) the way in which the Income Tax Office deals with your annual return

EV	17	42	57	24	41	26	= 207
NE	27	51	72	24	20	11	= 205

(significant difference)

(b) paying income tax by way of *provisional tax*

EV	24	10	18	13	43	99	= 207
NE	100	4	9	15	24	53	= 205

(no difference)

(c) "official investigations" by Income Tax Officers, of your tax affairs?

EV	17	14	23	29	43	81	= 207
NE	103	13	15	36	22	16	= 205

(significant difference)

5. Some people have a good idea of the *penalties* for cheating on their income tax returns but others have no idea. If a friend asked you what the penalties were, what would you say?

			<u>EV</u>	<u>NE</u>
I have	...	almost no idea	19	39
	...	very little idea	25	51
	...	some idea	50	64
	...	a fairly good idea	59	40
	...	a very good idea	<u>54</u>	<u>11</u>
			207	205
			(significant difference)	

6. We all hear about people cheating on their income tax returns but some of us hear about it more often than others. If ten (10) people known to you were "*officially investigated*" by Income Tax Officers how many do you think would be discovered:

- (a) cheating a little (say omitting less than \$100 earnings)

EV - average = 4.976
NE - average = 3.756 ANOVA (significant difference)

- (b) cheating a lot (say omitting more than \$1,000 earnings)

EV - average = 3.995
NE - average = 2.673 ANOVA (significant difference)

- (c) cheating a great deal (say omitting more than \$10,000 earnings)

EV - average = 2.870
NE - average - 2.449 ANOVA (no difference)

Not Very **Extremely**
Serious Serious Serious

7. On a scale of one (1) to five (5), how serious would you rate the following offences:

- (a) Stealing, from a large retail store, goods valued at:

(i)	\$100	EV	17	7	54	14	115	= 207
		NE	16	20	56	15	98	= 205
					(no difference)			
(ii)	\$1,000	EV	1	8	29	27	142	= 207
		NE	3	2	37	34	129	= 205
					(no difference)			
(iii)	\$10,000	EV	1	-	14	7	185	= 207
		NE	3	-	19	13	170	= 205
					(no difference)			

- (b) Evading income tax of;

(i)	\$100	EV 121	20	31	6	29	= 207
		NE 82	32	40	15	36	= 205
			(significant difference)				
(ii)	\$1,000	EV 42	37	53	31	44	= 207
		NE 20	27	60	35	63	= 205
			(significant difference)				
(iii)	\$10,000	EV 21	13	31	17	125	= 207
		NE 6	6	27	21	145	= 205
			(significant difference)				

- EV - average 36.3¢ ANOVA (no difference)
NE - average 36.8¢

Almost Certainly Omit it	Very Likely Omit it	Not Sure	Very Likely Include it	Almost Certainly Include it
--------------------------------	---------------------------	-------------	---------------------------------	--------------------------------------

9. When completing an income tax return, what do you think someone like yourself would do about cash earnings from a part-time job if they amounted to:

(i)	\$100	EV	84	51	24	14	34	= 207
		NE	95	46	22	15	27	= 205
			(no difference)					
(ii)	\$1,000	EV	22	28	35	56	66	= 207
		NE	19	35	31	49	71	= 205
			(no difference)					
(iii)	\$10,000	EV	6	6	23	32	140	= 207
		NE	6	7	23	27	142	= 205
			(no difference)					

A very good chance	A good chance	I have no idea	A poor chance	A very poor chance
1	2	3	4	5

10. Some people find it easy to *successfully* hide income from the tax man whereas others find it hard. What chance would someone like yourself have of *successfully* hiding income from the tax man of, say

(i)	\$100	EV	73	27	26	32	49	= 207
		NE	76	42	20	30	37	= 205
			(no difference)					
(ii)	\$1,000	EV	17	28	14	55	93	= 207
		NE	16	28	34	49	78	= 205
			(significant difference)					
(iii)	\$10,000	EV	4	10	12	21	160	= 207
		NE	2	3	18	27	155	= 205
			(no difference)					

Q.11 (a) How old are you?		<u>EV</u>	<u>NE</u>
	Under 25	0	28
	25 and under 40	48	79
	40 and under 60	114	64
	60 and over	<u>45</u>	<u>34</u>
		<u>207</u>	<u>205</u>

(significant difference)

(b) Which of the following best describes you?		<u>EV</u>	<u>NE</u>
	Self employed	88	26
	Employed (either full or part-time)	81	109
	Retired	27	26
	Housewife	9	34
	Other (e.g. student or unemployed)	<u>2</u>	<u>10</u>
		<u>207</u>	<u>205</u>

(significant difference)

(c) How much do you currently earn a year?		<u>EV</u>	<u>NE</u>
	Under \$4,195	<u>15</u>	<u>48</u>
	\$4,195 - \$17,894	109	110
	\$17,895 - \$35,788	72	43
	Over \$35,788	<u>11</u>	<u>4</u>
		<u>207</u>	<u>205</u>

(significant difference)

(d) Were you born in Australia?		<u>EV</u>	<u>NE</u>
	Yes	<u>135</u>	<u>167</u>
	No	71	37
	Don't know	<u>1</u>	<u>1</u>
		<u>207</u>	<u>205</u>

(significant difference)



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Department of Commerce

Dear

Recently I mailed you a questionnaire asking for your help in an important survey.

If you have already returned the questionnaire, please consider this letter a *thank you* for your help.

If you have not had a chance to do so yet, may I ask you to return the completed questionnaire now. Your participation is vital to the success of this project.

Yours sincerely,

IAN G. WALLSCHUTZKY
Lecturer in Commerce

APPENDIX 2

AVOIDANCE SURVEY MATERIAL

This appendix contains a copy of: -

- (i) The letter accompanying the questionnaire,
- (ii) The questionnaire and responses to each question, and
- (iii) The follow up letter.



THE UNIVERSITY OF NEWCASTLE
NEW SOUTH WALES, 2308

360

Department of Commerce
Telephone 68 0401

Extension

683

or

735

(Area Code 049)

Dear Fellow Tax Agent,

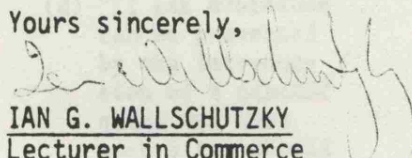
Many people complain about our income tax system but few people seem to do anything about it. I am conducting a research project to determine exactly what tax agents think about it. *You can help.*

Enclosed is a questionnaire which seeks your answers to various aspects of our tax system. If you would like to help, complete it and return it to me. It will not take much of your time and your answers will help my research.

Your name has been selected *by chance* from a list of tax agents and the questionnaire has not been marked or coded in any way so no one will know which answers are yours. The survey is independent of any Government Department or political party so you can say exactly what you *really think*. All answers will, of course, be treated in the strictest confidence.

Please return the completed questionnaire in the reply paid envelope WITHIN ONE WEEK. Thank you for your help.

Yours sincerely,


IAN G. WALLSCHUTZKY
Lecturer in Commerce

P.S. As a token of my appreciation for completing the questionnaire I would like you to keep the enclosed biro.

* * *

- Q.1 Over the last ten years do you think that relations between the accountancy profession and the Australian Income Tax Office have improved or deteriorated?

	<u>No.</u>
Improved a great deal	68
Slightly improved	166
About the same	149
Slightly deteriorated	112
Deteriorated a great deal	63
Unable to answer	<u>22</u>
	<u>580</u>

- Q.2 Could you indicate the extent of your agreement/disagreement with the following:

	Strongly Agree	Slightly Agree	Neither Agree nor Disagree	Slightly Disagree	Strongly Disagree	
(a) "Taxpayers are much more willing to undertake tax avoidance schemes now than they were a year ago"	142	159	79	118	82	= 580
(b) "The accountancy profession should be actively engaged in designing reforms to prevent tax avoidance."	173	109	82	84	132	= 580
(c) "Self employed taxpayers do not have adequate tax allowances for superannuation or retirement benefit contributions."	321	104	46	66	43	= 580
(d) "If tax avoidance can be prevented by the introduction of a <i>capital gains tax</i> then such a tax should be introduced."	94	93	40	53	300	= 580
(e) "The <i>new section 260</i> will probably be effective in preventing taxpayers from undertaking tax avoidance schemes."	40	229	104	136	71	= 580
(f) The Commissioner might use the <i>new section 260</i> against some family transactions which previously he did not challenge."	93	284	113	63	27	= 580

Q.3 Could you indicate the extent of your approval/disapproval for the following:

Strongly Approve	Slightly Approve	Neither Approve nor Disapprove	Slightly Disapprove	Strongly Disapprove
------------------	------------------	--------------------------------	---------------------	---------------------

362

(a) The system of paying tax by way of <i>provisional</i> tax	138	179	68	88	107	= 580
(b) The use of trusts to carry on family businesses	222	121	85	62	90	= 580
(c) The Government's apparent determination to stamp out tax avoidance	360	120	49	19	32	= 580
(d) The "new section 260" (i.e. Part IVA) of the Act	138	205	146	51	40	= 580

Q.4 How satisfied/dissatisfied have you been with the *time* it takes the Income Tax Office to:

Very Satis- fied	Some- what Satis- fied	Neither Satisfied nor Dissatis- fied	Somewhat Dissatis- fied	Very Dissatis- fied	
89	221	138	106	26	= 580
29	89	86	201	175	= 580
25	124	103	200	128	= 580

Q.5 The Institute of Chartered Accountants has issued an exposure draft entitled "Proposed Statement of Taxation Standards". These standards, if accepted, would become mandatory and failure by members to comply could result in investigation and disciplinary action. One of the standards provides that "a member shall not promote, or assist in the promotion of any schemes or arrangements which have no commercial justification other than the avoidance of tax through exploitation of the revenue laws". (Paragraph 28). What is your opinion of *this* standard?

Strongly approve	234
Slightly approve	119
No opinion	55
Slightly disapprove	74
Strongly disapprove	98
	<u>580</u>

Q.6 In your opinion, why have taxpayers *most* wanted to engage in *tax avoidance*?

They have thought the tax laws have been unfair	39
They have wanted to emulate friends they have known who have successfully engaged in tax avoidance	30
They have been dissatisfied with the way the government has spent taxpayers' money	16
They have been dissatisfied with the treatment they have received from the Income Tax Office and have wanted to get even	-
They have thought the amount of tax they have paid in relation to the amount of money they have earned has been too high	428
Other (please specify) _____	67
	<u>580</u>

Q.7 Which of the following do you think has *most* often discouraged taxpayers from undertaking tax avoidance schemes?

The costs that have been associated with implementing those schemes	71
The complexity of the scheme	108
The expectation that benefits will only be temporary	64
The belief that such schemes are morally wrong	58
The possibility of protracted legal battles with the Tax Office	223
Other (please specify) _____	56
	<u>580</u>

Q.8 What do you think most professional people would most likely do when their income reaches the level where they have to pay the maximum marginal rate of tax (i.e. sixty cents in the dollar). They would:

Continue to work as before	10
Work <u>more</u> to counteract the effect of tax on their income	8
Limit their income by working <u>less</u>	47
Continue to earn, but look for ways of reducing their tax burdens by legal means	453
Continue to earn but seek ways of evading tax	57
Other (please specify) _____	5
	<u>580</u>

Q.9 (a) How many years have you been registered as a tax agent?

Five years or less	134
More than five but less than ten years	143
Ten years or more	<u>303</u>
	580

(b) Are you actively engaged in taxation work (for instance, do you earn, directly or indirectly, more than \$1,000 p.a. from doing taxation work)?

Yes	404
No	<u>176</u>
	580

(c) Are you a member of either the Institute of Chartered Accountants or the Australian Society of Accountants?

Both	72
Institute only	121
Society only	278
Neither	<u>109</u>
	580

TOTAL NUMBER OF QUESTIONNAIRES SENT	1,000
NUMBER OF USEABLE RESPONSES	580
RESPONSE RATE	58%
NUMBER OF REQUESTS FOR RESULTS	337



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Yours sincerely,

I. G. WALLSCHUTZKY
Lecturer in Commerce